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TRANSCRIPT OF RECORD

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1937

No. 723

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

vs.

NATIONAL GROCERY COMPANY

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT

PETITION FOR CERTIORARI FILED JANUARY 20, 1938
CERTIORARI GRANTED FEBRUARY 28, 1938

SUPREME COURT OF THE UNITED STATES

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NATIONAL GROCERY COMPANY

WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT

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Docket Entries.

United States Circuit Court of Appeals

THIRD CIRCUIT.

NATIONAL GROCERY COMPANY, Petitioner, *vs.* COMMISSIONER OF INTERNAL REVENUE, Respondent.	DOCKET No. 76600.

Appearances:

For Petitioner: John M. Enright, Esq., James D. Carpenter, Jr., Esq.

For Respondent: Ralph E. Smith, Esq., Timothy C. Mooney, Esq.

1934

June 8—Petition received and filed. Taxpayer notified. (Fee paid.)

June 8—Copy of petition served on General Counsel.

June 27—Answer filed by General Counsel.

July 5—Copy of answer served on taxpayer.

Nov. 16—Motion to place on New York Calendar filed by taxpayer.

Nov. 19—Order placing on Circuit Calendar for hearing in New York City entered.

1936

Mar. 5—Hearing set May 7, 1936, New York, N. Y.

May 7—Hearing had before Mr. Smith on merits—submitted. Notice of appearance of Mr. Carpenter filed. Petitioner's brief due 6/22/36—respondent's brief due 7/8/36—petitioner's reply 7/23/36.

May 18—Transcript of hearing of May 7, 1936 filed.

July 10—Motion for leave to file brief filed by taxpayer—brief attached. 7/11/36 granted.

July 11—Brief filed by taxpayer.

July 13—Copy of motion and brief served on General Counsel.

Sept. 12—Motion for leave to file brief filed by General Counsel—brief lodged. 9/14/36 granted.

Oct. 26—Motion for leave to file reply brief filed by taxpayer. 10/26/36 granted.
Oct. 26—Reply brief filed by taxpayer.
Oct. 26—Copy of motion and reply brief served on General Counsel.
Dec. 9—Findings of fact and opinion rendered—Charles P. Smith, Division 5. Judgment will be entered for the respondent.
Dec. 10—Decision entered—Charles P. Smith, Division 5.

1937

Jan. 5—Petition for review by U. S. Circuit Court of Appeals, 3rd Circuit, with assignments of error filed by taxpayer—proof of service thereon.
Jan. 22—Agreed statement of evidence lodged.
Jan. 22—Agreed praecipe filed—with proof of service thereon.
Jan. 23—Agreed statement of evidence approved and ordered filed.

Petition.

(Filed June 8, 1934.)

UNITED STATES BOARD OF TAX APPEALS

NATIONAL GROCERY COMPANY, Petitioner. vs. COMMISSIONER OF INTERNAL REVENUE, Respondent.	DOCKET No. 76600.

The above named petitioner hereby petitions for a redetermination of the deficiency set forth by the Commissioner of Internal Revenue in his notice of deficiency IT: AR: B-3, dated April 25, 1934, and, as a basis of its proceeding, alleges as follows:

1. Petitioner is a corporation created by and existing under the laws of the State of New Jersey, having its principal office and place of

business at No. 300 Mercer Street, Jersey City, N. J.

2. The notice of deficiency (a copy of which is attached and marked Exhibit A) was mailed to the petitioner bearing a stamp postmarked dated April 25, 1934.

3. The tax in controversy is an income tax for the fiscal year ended January 31, 1931.

The amount of the alleged deficiency is $477,360.68, of which the amount of $477,322.81 is in controversy.

4. The determination of tax set forth in the said notice of deficiency is based upon the following errors:

(a) The entire amount of the alleged determination except the sum of $37.87, purports to be based upon the application of Section 104 of the Revenue Act of 1928, whereas said section has no lawful application to the income of petitioner, and the determination of deficiency based thereon is contrary to law.

(b) The determination of alleged deficiency to the extent of $477,322.81, purports to be based upon the application of Section 104 of the Revenue Act of 1928, notwithstanding petitioner corporation was not formed or availed of for the purpose of preventing the imposition of the surtax upon its shareholders through the medium of permitting its gains or profits to accumulate instead of being divided or distributed, within the true intent and meaning of said statute.

(c) The determination of alleged deficiency to the extent of $477,322.81, purports to be based upon the application of Section 104 of the Rev-

enue Act of 1928, and presumes, without any real determination, that petitioner corporation during the period in question was formed or availed of for the purpose of preventing the imposition of the surtax upon its shareholders through the medium of permitting its gains or profits to accumulate instead of being divided or distributed; notwithstanding said corporation was, in fact, organized for the purpose of conducting a mercantile and manufacturing business in 1908, and has ever since been engaged in said business, and was so engaged during the fiscal year ending January 31, 1931, and during said year operated 812 retail stores, with sales of merchandise amounting to $25,142,537.41, and owned and operated in connection with said business administrative offices, warehouses, manufacturing plants and apparatus, stables and garages, a large bakery, extensive delivery equipment, store fixtures and furniture, and a miscellaneous stock of merchandise contained in its retail stores and distributing warehouses; and the business of the petitioner corporation was not and at no time has been or is a mere holding or investment company, nor have its gains or profits been permitted to accumulate beyond the reasonable needs of its business, within the intent and meaning of Section 104 (b) of said Revenue Act.

(d) The purported determination of additional tax by the Deputy Commissioner of Internal Revenue is not based upon any lawful determination or finding that petitioner corporation was formed or availed of for the purpose of preventing the imposition of the surtax upon its shareholders, nor upon any lawful determination or finding that petitioner corporation permitted its gains or profits to accumulate beyond the reasonable needs of its business.

(e) The determination of deficiency assumes that the entire net income of petitioner corporation for the period in question, before deduction of income taxes and dividends paid, was accumulated for the purpose of preventing the imposition of the surtax upon its shareholders, notwithstanding the fact appearing upon the report dated April 24, 1932, of Revenue Agent S. H. Bischoff, referred to in the statement attached to the determination of the Commissioner, that said net income was applied during said period in part to the payment of income taxes for the preceding year amounting to $94,588.25, and to the payment of a dividend to shareholders, paid March 17, 1930, amounting to $100,000., and that said corporation was subject to an income tax for the then current year under Section 13 of said Revenue Act at the rate of 12%, amounting to $103,654.47, which has since been paid.

(f) The Commissioner of Internal Revenue did not, in fact, within the time required by law, make any determination of the essential facts necessary for the determination of additional tax under the provisions of Section 104 of the Revenue Act of 1928, the sixty day letter or notice of the Deputy Commissioner attached hereto being issued for the sole and only purpose of preventing the running of the Statute of Limitations, pending action by the Commissioner upon an offer in compromise submitted by the taxpayer under date of December 28, 1933, at the instance and request of the Commissioner.

(g) Section 104 of the Revenue Act of 1928, as construed and applied by the Commissioner of Internal Revenue, or his deputy, to the income of petitioner for the fiscal year ending January 31,

1931, violates rights secured to the petitioner under the Constitution of the United States.

5. The facts upon which the petitioner corporation relies as the basis of this proceeding are as follows:

(a) Petitioner is a business corporation organized under the laws of the State of New Jersey June 2, 1908, for the purpose of developing, owning, and operating a chain store system of grocery stores, operating from an administrative and distributing center in Jersey City, New Jersey, with retail stores covering an expanding area of adjacent territory.

The business originated with a single neighborhood store conducting a small business in 1891, with an investment of a few hundred dollars, and was incorporated in 1908.

It now includes 814 stores spread over an area covering the north central part of New Jersey and extending into the State of New York, with plans for eventual extension into adjacent territory in the City of New York and the populous adjoining territory of Westchester County, New York.

In developing this business and for the service thereof, the Company has acquired and operates a large central distributing plant in Jersey City, the buildings covering more than a city block, and including a general administration building, a large bakery, garages, stables, coffee roasting plant, and storage warehouses.

The Company has also acquired and operates a large fleet of automobiles and horse drawn trucks and other transportation equipment, and at all

times carries very large stocks of merchandise in its various stores and warehouses.

The Company was built and has developed wholly upon the principle of the accumulation of profits and investment thereof in the business.

The merchandise sales of the petitioner corporation for the fiscal year in question, ending January 31, 1931, amounted to $25,142,537.41.

The aim and purpose of the petitioner is to ultimately expand its business to a chain of not less than 2000 stores.

This business policy has long been held but the rate and territory of expansion has been necessarily checked and temporarily modified by the business uncertainties of the last few years.

The actual value of the assets of petitioner corporation has suffered enormous shrinkage during the depression, which shrinkage, however, is not reflected in the returns made for purposes of income taxation, or upon the books of the Company in the case of assets which have not been sold.

The officers, directors and stockholders of the Company determined in the exercise of their business judgment based upon their experience in the business, that the net income of the Company for the period in question should be retained in the Company and not distributed except to the extent that the same was required in the payment of taxes and the dividend paid during that year, having in contemplation the present requirements and the future business plans of the Company and the shrinkage in its net asset position resulting from the depreciation of its assets; and that the actual capital and surplus on hand at the end of said

fiscal year did not exceed the reasonable needs of the business then existing or anticipated.

(b) The Commissioner of Internal Revenue has not, in fact, made any finding or determination that petitioner corporation was formed or availed of for the purpose of preventing the imposition of surtax upon its shareholders within the intent and meaning of Section 104 of the Revenue Act of 1928.

(c) The Commissioner of Internal Revenue has not, in fact, made any finding or determination of the amount of capital which the petitioner may lawfully invest in its business, or which is necessary for the reasonable needs of the business, and without such determination has not and cannot determine the amount of gains or profits which petitioner may lawfully accumulate for the reasonable needs of its business without incurring the penalties of Section 104 of the Revenue Act of 1928.

(d) Petitioner throughout the fiscal year in question was engaged in the lawful business of a merchant and manufacturer, and lawfully entitled to develop and expand its business and to accumulate the profits thereof for such purpose, and the amount so accumulated out of the profits for the fiscal year in question was within the lawful discretion of petitioner and its officers and directors.

WHEREFORE, petitioner prays that this Board may hear the proceeding and set aside and vacate the determination of income tax liability made by the Deputy Commissioner of Internal Revenue set

forth in the notice hereto annexed, and that petitioner may have such other relief as may be proper.

(Corporate Seal) NATIONAL GROCERY COMPANY,

By HENRY KOHL, President,

(Henry Kohl), Petitioner.

Attest:

ALBERT B. VANCLIEF,

(Albert B. VanClief), Secretary.

JOHN M. ENRIGHT,

(John M. Enright)

Counsel for Petitioner,

Office and postoffice address,

75 Montgomery Street,

Jersey City, N. J.

STATE OF NEW JERSEY }
HUDSON COUNTY } ss.:

HENRY KOHL, being duly sworn, according to law, on his oath deposes and says:

That he is the President of National Grocery Company, the petitioner above named, and that he is duly authorized to verify the foregoing petition; that he has read the foregoing petition and is familiar with the statements contained therein, and that the facts stated are true, except as to those facts stated upon information and belief, and those facts he believes to be true.

HENRY KOHL.

Subscribed and sworn to before me this 7th day of June, 1934.

THOMAS J. BOTTI,
Notary Public of New Jersey.

(Seal of Notary affixed)

Petition.

Exhibit A.

IT:AR:B-3 NP-2-1 act
AM-60D Apr 25 1934

National Grocery Company,
300 Mercer Street,
Jersey City, New Jersey.

Sirs:

You are advised that the determination of your income tax liability for the fiscal year(s) ended January 31, 1931, discloses a deficiency of $477,-360.68 as shown in the statement attached.

In accordance with section 272 of the Revenue Act of 1928, notice is hereby given of the deficiency mentioned. Within sixty days (not counting Sunday as the sixtieth day) from the date of the mailing of this letter, you may petition the United States Board of Tax Appeals for a redetermination of the deficiency.

HOWEVER, IF YOU DO NOT DESIRE TO PETITION, you are requested to execute the enclosed form and forward it to the Commissioner of Internal Revenue, Washington, D. C., for the attention of IT:C:P-7. The signing of this form will expedite the closing of your return(s) by permitting an early assessment of any deficiency and preventing the accumulation of interest charges, since the interest period terminates thirty days after filing the form, or on the date assessment is made, whichever is earlier; WHEREAS IF THIS FORM IS NOT FILED, interest at the rate of 6% per annum will accumulate.

Respectfully,

(Signed) CHAS. T. RUSSELL
Deputy Commissioner.

Enclosures:
Statement
Form 870

cab-2

STATEMENT

IT:AR:B-3
AM-60D

In re: National Grocery Company,
300 Mercer Street,
Jersey City, New Jersey.
Income Tax Liability

Year	Income Tax Liability	Income Tax Assessed	Deficiency
Fiscal ended January 31, 1931	$580,977.28	$103,616.60	$477,360.68

Careful consideration has been given your income tax return in connection with your protest against the action proposed in Bureau letter dated December 9, 1932.

The deficiency shown herein is based upon the report dated April 24, 1932, prepared by Revenue Agent S. H. Bischoff and transmitted to you under date of June 9, 1932, and upon such adjustments as follows:

	Income	
Net income reported on return		$863,471.67
Add:		
(a) Store fixtues salvaged		601.50
(b) Resetting expense, store fixtures		763.90
Total		$864,837.07
Less:		
(c) Additional depreciation allowable	$471.75	
(d) Adjustment of sale of stock	578.10	1,049.85

Petition.

Net income taxable under section 13 of the Revenue Act of 1928	$863,787.22
National Grocery Company.	Statement.
Brought Forward	$863,787.22
Add:	
(e) Interest on obligations of the United States and its Possessions	175.00
Dividends deducted under section 23(p) of the Revenue Act of 1928	90,683.40
Net income as adjusted, taxable under section 104(c) of the Revenue Act of 1928	$954,645.62

Explanation of Changes

(a) The salvage value of fixtures in abandoned stores is restored to income. Article 171, Regulations 74.

(b) The cost of transferring salvaged fixtures (including the above) in the amount of $763.90 is restored to income since it is considered part of the salvaged fixture account.

(c) Depreciation on salvaged fixtures is allowed as follows:

Salvaged in prior years $1,676.06 at 20%	$335.21
Salvaged in prior years $1,365.40 at 10%	136.54
Total allowed	$471.75

(d) The gain reported on the sale of Equitable Trust Company stock has been reduced by the overstated cost of $578.10.

(e) Under the provisions of section 104 of the Revenue Act of 1928, the net income is the net income as defined in section 21 of the Act increased by the sum of

the amount of dividend deduction allowed under section 23(p) of the Act and the amount of interest on obligations of the United States issued after September 1, 1917, which would be subject to tax in whole or in part in the hands of an individual owner.

National Grocery Company. Statement.

Computation of Tax

Net income taxable under section 13 of the Revenue Act of 1928	$863,787.22	
Income tax liability at 12%		$103,654.47
Net income taxable under section 104(c) of the Revenue Act of 1928	$964,645.62	
Income tax liability at 50%		477,322.81
Total income tax liability		$580,977.28
Income tax previously assessed		103,616.60
Deficiency		$477,360.68

After careful consideration of your protest dated July 19, 1932 and subsequent information furnished this office, the Bureau approves the revenue agent's conclusion that in accordance with the provisions of section 104 of the Revenue Act of 1928 your company has permitted its gains and profits to accumulate beyond the reasonable needs of the business instead of being distributed, which is construed as prima facie evidence of a purpose to prevent imposition of surtax upon its stockholders.

The deficiency shown above represents your income tax liability as determined under the provisions of sections 13 and 104 of the Revenue Act of 1928.

The waiver included with the compromise offer, Form 656, does not specifically cover the assessment of the pro-

posed income tax liability in issue, and since the assessment period as otherwise extended will expire on April 30, 1934, and since final action on the compromise cannot be taken prior to the expiration of the limitation period, it is necessary at this time to issue this formal notice of deficiency in accordance with the provisions of the Revenue Acts.

A copy of this communication has been forwarded to your representatives, Messrs. John M. Enright and James D. Carpenter, Jr., 75 Montgomery Street, Jersey City, New Jersey, in accordance with the authority conferred upon them in the power of attorney executed by you and on file with the Bureau.

AM/LLR-3

Answer.

UNITED STATES BOARD OF TAX APPEALS

NATIONAL GROCERY COMPANY, Petitioner, v. COMMISSIONER OF INTERNAL REVENUE, Respondent.	DOCKET No. 76600.

The respondent, by his attorney, Robert H. Jackson, Assistant General Counsel for the Bureau of Internal Revenue, for answer to the petition of this taxpayer, filed June 8, 1934, admits and denies as follows:

Answer.

1, 2, 3. Admits the averments contained in paragraphs 1, 2, and 3 of the petition.

4. Admits that the entire amount of the determination of deficiency except the amount of $37.87 is based upon the application of Section 104 of the Revenue Act of 1928; admits the payment by petitioner of $103,654.47 income tax for the fiscal year ended January 31, 1931; denies the remaining averments contained in paragraph 4.

5. For lack of sufficient knowledge to form an opinion, denies the averments contained in paragraph 5 and will require proof thereof at the hearing of this appeal.

WHEREFORE, it is prayed that the taxpayer's appeal be denied.

(Signed)

ROBERT H. JACKSON
Assistant General Counsel for the
Bureau of Internal Revenue.

Of Counsel:
HAROLD ALLEN
R. H. TRANSUE
Special Attorneys
Bureau of Internal Revenue.

HA-afh 6-23-34

Findings of Fact and Opinion.

UNITED STATES BOARD OF TAX APPEALS

NATIONAL GROCERY COMPANY, PETITIONER, v. COMMISSIONER OF INTERNAL REVENUE, RESPONDENT.

Docket No. 76600. Promulgated December 9, 1936.

Petitioner was incorporated in 1908 for the purpose of operating a chain of grocery stores. Very little of its profits has ever been distributed to its sole stockholder in the form of dividends. During recent years a large part of its surplus profits has been invested in bonds and stocks, which suffered a large decline in market value during the fiscal year ended January 31, 1931. During that fiscal year, and for a number of years prior thereto, the petitioner loaned to its sole stockholder large amounts of money upon which no interest has been paid to the petitioner. *Held* that for the fiscal year ended January 31, 1931, the corporation is liable to tax under section 104 of the Revenue Act of 1928.

James D. Carpenter, Jr., Esq., and *John M. Enright, Esq.*, for the petitioner.

Ralph E. Smith, Esq., and *Timothy C. Mooney, Esq.*, for the respondent.

This is a proceeding for the redetermination of a deficiency in income tax for the fiscal year ended January 31, 1931, of $477,360.68. The petitioner alleges that the respondent erred in holding it liable to tax under section 104 of the Revenue Act of 1928, and also that section 104 is unconstitutional.

Findings of Fact and Opinion.

FINDINGS OF FACT.

The petitioner was incorporated under the laws of the State of New Jersey in 1908 for the purpose of operating a chain of grocery stores. Its authorized capital stock was $5,000, divided into 50 shares of a par value of $100 each. All of the shares were beneficially owned by Henry Kohl. At the time of incorporation the business consisted of three stores. They were all operated upon a "cash and carry" basis. The business prospered and with the profits, all of which were retained in the business, additional stores were acquired. In 1911 there was an amendment to the charter and the capital stock was increased to $200,000, all of which was beneficially owned by Kohl. The capitalization of the company has never been increased from that amount and Kohl has always beneficially owned all of the shares of stock. The annual net profits of the business, as shown by petitioner's books of account for the fiscal years ended January 31, 1923, to January 31, 1931, have always been in excess of $500,000. The net profits for the last four fiscal years above referred to were as follows:

January 31, 1928	$818,043.54
January 31, 1929	870,144.92
January 31, 1930	806,507.32
January 31, 1931	786,466.98

During the same period petitioner paid a salary to Henry Kohl of $2,000 per week. The number of stores operated at the end of each of the fiscal years ending in 1928, 1929, 1930, and 1931 were 715, 782, 799, and 815, respectively.

For many years the petitioner has contemplated greatly expanding the number of stores operated. For a time it negotiated for the pur-

chase of stores in Paterson, New Jersey, and also for stores in New York City proper, and for a large chain of stores in Brooklyn, New York. The petitioner has not, however, made the contemplated expansions because in the opinion of the petitioner's president, Henry Kohl, the stores could not be purchased at what he regarded as a fair price.

For a long period of years the surplus profits of the business have been invested in stocks and bonds. At the end of the fiscal year January 31, 1931, the petitioner owned shares of stock in 58 industrial corporations, 24 public utilities, 18 insurance companies, 16 investment trusts, and 24 banks, and the bonds of many companies. The surplus was thus invested in order to obtain a greater return therefrom than would have been obtained from bank deposits and with the thought in mind of realizing cash thereon for the purpose of expanding its chain of grocery stores at any time desired.

The only dividends the petition has ever paid to its sole stockholder up to January 31, 1931, were a dividend of $25,000 in 1917, and a dividend of a like amount in 1918. Petitioner had, however, advanced money to its sole stockholder to an amount of $394,100 to January 26, 1925. These advances were made on notes bearing interest at 6 percent per annum, although no interest has ever been charged or paid thereon. After January 26, 1925, the petitioner also loaned to its sole stockholder additional amounts on demand notes bearing no interest, and the aggregate amount of the loans to the petitioner up to January 31, 1931, totaled $610,000. During the fiscal year ended January 31, 1931, the petitioner loaned to its sole stockholder, without interest,

$140,000, $40,000 of which amount was to enable Kohl to acquire a house in Florida and $100,000 to enable him to make a personal charitable contribution of that amount to a Y. W. C. A. A considerable portion of the loans made to the petitioner were canceled by dividends declared by the petitioner after January 31, 1931, although the outstanding loans to the petitioner on April 23, 1936, still stood at $424,000. The balance sheets of the petitioner for the fiscal years ended January 31, 1928, to January 31, 1931, inclusive, show as follows:

ASSETS

	Fiscal years ended			
	1/31/28	1/31/29	1/31/30	1/31/31
Cash	$ 659,734.40	$ 890,397.59	$1,332,332.28	$1,405,961.04
Notes receivable	424,100.00	460,000.00	470,000.00	610,000.00
Accounts receivable	1,888.82	3,975.19	26,816.37	3,220.85
Inventories	2,615,057.67	2,917,716.55	3,189,396.72	2,812,939.16
Mortgage	59,000.00	59,000.00	59,000.00	59,000.00
Bonds	256,114.76	96,820.30	59,435.00	313,391.27
Stocks	2,169,687.62	2,318,074.13	2,720,283.07	2,676,061.47
Other	6,236.39	7,425.08	10,150.89	20,686.18
Deferred	33,338.64	25,685.23	31,875.79	29,687.74
Permanent	1,542,129.60	1,501,193.83	1,345,976.63	1,177,489.43
Total	$7,767,287.90	$8,280,287.90	$9,245,266.75	$9,108,437.14

LIABILITIES

Notes payable and mortgages	$1,008,750.00	$ 700,000.00	$ 790,000.00	$ .....
Accounts payable	258,889.61	270,318.54	371,121.96	269,140.49
Accrued	7,742.15	7,385.56	19,757.11	7,411.70
Reserve income tax	93,933.45	72,035.56	52,592.97	51,330.42
Reserve insurance	417,797.77	491,032.34	565,970.45	641,588.99
Capital stock and surplus	5,980,174.92	6,739,515.90	7,445,824.26	8,138,965.54
Total	$7,767,287.90	$8,280,287.90	$9,245,266.75	$9,108,437.14

Findings of Fact and Opinion.

The fair market value of the securities owned on January 31, 1931, was $2,125,434.50 as against their cost of $2,989,452.74.

The petitioner was availed of during the fiscal year ended January 31, 1931 for the purpose of preventing the imposition of the surtax upon its sole stockholder "through the medium of permitting its gains and profits to accumulate instead of being divided or distributed."

OPINION.

SMITH: The first question presented by this proceding is whether the petitioner is liable to tax under section 104 of the Revenue Act of 1928 upon its profits for the fiscal year ended January 31, 1931. That section, so far as material to this proceeding, is as follows:

(a) If any corporation, however created or organized, is formed or availed of for the purpose of preventing the imposition of the surtax upon its shareholders through the medium of permitting its gains and profits to accumulate instead of being divided or distributed, there shall be levied, collected, and paid for each taxable year upon the net income of such corporation a tax equal to 50 per centum of the amount thereof, which shall be in addition to the tax imposed by section 13 and shall be computed, collected, and paid upon the same basis and in the same manner and subject to the same provisions of law, including penalties, as that tax.

(b) The fact that any corporation is a mere holding or investment company, or that the gains or profits are permitted to accumulate beyond the reasonable needs of the business, shall be prima facie evidence of a purpose to escape the surtax.

Findings of Fact and Opinion.

In his deficiency notice the respondent stated:

After careful consideration of your protest dated July 19, 1932 and subsequent information furnished this office, the Bureau approves the revenue agent's conclusion that in accordance with the provisions of section 104 of the Revenue Act of 1928 your company has permitted its gains and profits to accumulate beyond the reasonable needs of the business instead of being distributed, which is construed as prima facie evidence of a purpose to prevent imposition of surtax upon its stockholders.

Does the evidence overcome this prima facie presumption? And, if so, was the petitioner "availed of for the purpose of preventing the imposition of the surtax upon its shareholders through the medium of permitting its gains and profits to accumulate instead of being divided or distributed", during the taxable year?

The petitioner was organized for the purpose of operating a chain of grocery stores. For a number of years after its organization the profits of the business were used in extending the chain. At some time prior to 1922 the petitioner began to invest a portion of its surplus profits in the purchase of bonds and stocks. Its balance sheet at January 31, 1922, shows its investment in bonds and stocks at $490,000 and $130,710, respectively. Its holdings of securities in subsequent years greatly increased. There was also, up to 1929, a very large increase in the market value of the securities acquired. Since 1929 the petitioner has not greatly expanded its grocery business. Its profits have been large but they have not been paid over to its sole stockholder in the form of dividends. Most of them have been invested in securities.

Petitioner's balance sheet at the beginning of the taxable year shows cash on hand of $1,332,-332.28; notes receivable (Henry Kohl), $470,000; accounts receivable, $26,816.37; bonds, mortgages, and stocks, $2,838,718.07; and other current assets against actual liabilities (exclusive of reserves) of $1,180,879.07. At the end of the taxable year petitioner's balance sheet shows cash, $1,405,961.04; notes receivable (Henry Kohl), $610,000; bonds, mortgages, and stocks, $3,048,-452.74; and other current assets against the actual liabilities (exclusive of reserves) of only $276,-552.19. Its actual surplus at January 31, 1931, was $7,938,965.54.

The petitioner contends that this large surplus was of benefit to it in obtaining credit at banks and in enabling it to purchase merchandise at a low price. It appears, however, that the petitioner's credit had been excellent for many years prior to the taxable year and that it did not obtain loans from banks at a lower rate of interest simply because it had a large investment in bonds and stocks. Manifestly, the amounts invested in bonds and stocks were not used by the petitioner either in the taxable year or for several years prior or subsequent thereto in its grocery business. We find as a fact that the petitioner's accumulation of earnings was far in excess of the "reasonable needs" of the corporate business.

We are also of the opinion that the evidence of record does not rebut the prima facie presumption created by the statute that the accumulation of earnings beyond the "reasonable needs of the business" was for the purpose of preventing the imposition of the surtax upon its sole stockholder. The evidence shows that Henry Kohl, personally, needed some of the profits of the business. Prior to the taxable year he had borrowed from the

petitioner $470,000, and, during the taxable year, he borrowed an additional amount of $140,000. No interest was ever charged or paid upon these loans. If the amount borrowed during the taxable year had been distributed as a dividend the petitioner would have been subject to a large surtax upon it. By reason of the failure to pay the $140,000 as a dividend the petitioner escaped surtax upon that amount of income. See *William C. DeMille Productions, Inc.*, 30 B. T. A. 826.

Upon the evidence before us we have made the finding that the petitioner was "availed of" during the fiscal year ended January 31, 1931, for the purpose of preventing the imposition of the surtax upon its sole stockholder "through the medium of permitting its gains and profits to accumulate instead of being divided or distributed." Cf. *United Business Corporation of America*, 33 B. T. A. 83; *R. & L., Inc.*, 33 B. T. A. 857.

The petitioner contends that: "Section 104 of the Revenue Act of 1928, as construed and applied by the Commissioner of Internal Revenue, or his deputy, to the income of petitioner for the fiscal year ending January 31, 1931, violates rights secured to the petitioner under the Constitution of the United States." It has not, however, advanced any argument in support of this proposition in its brief, and the constitutionality of the provision is sustained upon the authority of *United Business Corporation of America* v. *Commissioner* (C. C. A., 2d Cir.), 62 Fed. (2d) 754; certiorari denied, 290 U. S. 635; *United States* v. *Tway Coal Sales Co.* (C. C. A., 6th Cir.), 75 Fed. (2d) 336; *Williams Investment Co.* v. *United States*, 3 Fed. Supp. 225; 77 Ct. Cls. 396.

Reviewed by the Board.

Judgment will be entered for the respondent.

MELLOTT, dissenting: The majority holding, that the act is not unconstitutional, is, in my judgment, correct. I have considerable doubt, however, that the tax and penalty prescribed by it should be assessed and imposed under the facts before us.

The petitioner corporation was not formed for the purpose of preventing the imposition of the surtax upon its shareholders. It was formed many years prior to the enactment of the income tax law and for the purpose, as set out in the prevailing opinion, "of operating a chain of grocery stores."

Was it "availed of" during the taxable year for the inhibited purpose? The respondent contends that it was. In his notice of deficiency it is stated that he "approves the revenue agent's conclusion that * * * [it] * * * permitted its gains and profits to accumulate beyond the reasonable needs of the business." Such determination apparently was made under section 104 (b) of the Revenue Act of 1928, which prescribes that such a finding is prima facie evidence of a purpose to evade the surtax.

It may, or may not, be significant that the respondent did not categorically find that petitioner was "availed of" for the interdicted purpose; but such finding must be made by this Board if it is to approve the deficiency. Before we make such finding, however, there should be at least a fair preponderance of the evidence to support it, and I am not satisfied that such requirement has been met.

The prevailing opinion makes reference to three or four facts relied upon as being particularly significant—that the profits, though large, were

not paid over to the sole stockholder in the form of dividends but were invested partially in securities; that the surplus increased during the taxable year; and that the sole stockholder borrowed from the petitioner certain sums of money without interest. These are circumstances which should be considered, but I do not think, upon this record, that they are so indicative of the nefarious purpose as to compel the conclusion reached by the majority.

The respondent offered no evidence, except a statement of the cost and market value of the securities, prepared from the books of the company, and the income tax returns of the petitioner and its sole stockholder. The petitioner produced several witnesses. At the risk of unduly extending this discussion, I feel impelled to make reference to some of the facts established by the evidence.

The treasurer of the company, who had been associated with the sole stockholder for more than 30 years, stated that, in her opinion, the surplus was not in excess of the reasonable needs of the business. She testified that to carry on the business, to buy the large quantities of merchandise required, and to pay the other expenses of the business, required a large surplus and that even with the large surplus on hand, there were times when the company was short of cash and had to borrow temporarily from the banks in order to pay the invoices of incoming merchandise.

Kohl, the sole stockholder, when asked why he kept all of the earnings of the company in the business instead of drawing them out, stated, "I needed them in the business—always needed them in the business. I never had any too much money." He also stated that he always tried to hold the corporation ready at all times to buy, if necessary,

a whole year's supply of merchandise, if he thought that it could make money by doing so. When asked if, in his judgment, it was necessary for it to be continuously in the position of purchasing supplies in such quantity, he answered: "Well, the more money you have got, the cheaper you can buy and the more independent you are and the more you are recognized—and everything depends upon your statement, see?" It had been the policy of the business since its establishment "to keep in the statement and in the business every possible dollar and let them accumulate for the benefit of the business." From the very beginning the sole stockholder had followed the policy of living simply, drawing only enough salary to live on and confining his expenditures outside of the business to his living expenses. In its first year the company operated three stores; in 1912, 57; in 1915, 171; in 1918, 268; in 1923, 388; and, as shown in the findings above, in 1928, 715, and in 1931, 815. This growth corresponded in a general way with the ambition of the sole stockholder, one witness telling us that when he had 3 stores his ambition was to have 10; when he had 10, his ambition was to have 50; when he had 50, then to have 100, then 500, then 1,000, etc. With this idea in mind the warehouses, garages, bakery, and other facilities of the petitioner were expanded accordingly and such facilities now have sufficient capacity to take care of twice the number of stores which it owned during the taxable year.

Kohl further testified that before 1930 he had considered the purchase of a chain of stores in Paterson, New Jersey. During that year he also carried on negotiations with the owner of some 500 or 600 stores for their purchase. This was a business of from $5,000,000 to $6,000,000. While the stores were not actually purchased during

the taxable year, the fact that such purchase was contemplated is a significant circumstance which should be considered by this Board in passing upon the question at issue.

Petitioner sold approximately $20,000,000 worth of merchandise during the taxable year, and, by taking advantage of its discounts, earned almost a half million dollars. Its pay roll and rents alone amounted to $4,000,000 a year. During the taxable year it paid Federal income taxes of $103,616.60. If it and its officers had wished to avoid paying Federal taxes, a method far more efficacious than accumulating "an unreasonable surplus" could have been adopted. For instance, it could have sold some of its securities, which had depreciated in value more than a million dollars, deducted its loss, and thus not only could have saved on its income tax for that year, but in addition could have adjusted its surplus and earnings so that its books would show an actual loss for the taxable year instead of a gain or profit.

The petitioner paid its sole stockholder more than $100,000 a year as a salary. This was reported by him in his income tax return and tax was paid accordingly. It was ample for his ordinary living expenses and there was apparently no good reason why he should pay out any more of the earnings of the corporation to himself. He paid a surtax of more than $8,000 on his salary and a total tax of more than $11,000 for each of the four years 1928 to 1931, inclusive.

William J. Field, president of a large bank, testified that in his opinion the capital and surplus of petitioner was not in excess of the reasonable needs of the business, pointing out that at that time "we were starting on a panic and panic conditions. No one could foretell the future at

that time. The National Gocery Co. had a turnover of over six to eight times its capital in the volume of business it did in those years * * *. They had experienced in previous years rather large losses on inventory and felt they should keep a considerable working capital and surplus to meet any additional losses they might encounter." He also pointed out that the accumulation in surplus invested in securities enabled it to show a better credit statement and to borrow whenever it wished at low rates of interest. Frank C. Ferguson, another bank president, testified to substantially the same effect.

Another circumstance worthy of more than passing consideration is the fact that petitioner's real estate holdings, as well as its stocks and bonds, had materially depreciated in value. This depreciation, though it had not been reflected in the balance sheet, was nevertheless a very real thing. The stocks and bonds had depreciated more than $900,000. The merchandise inventory due to the general decline, had decreased approximately a quarter of a million dollars, while the fair market value of the real estate had a shrinkage in value, over and above the depreciation charged off, amounting to approximately $125,000.

Being concerned, as we are, with actualities—a rule which certainly should be applied when we are passing upon the applicability of a penal statute such as we have before us, and regardless of the fact that the books of the company reflected an addition to surplus, the above evidence clearly shows that during the taxable period before us there was no unreasonable accumulation of gains and profits.

Congress was very careful to limit this highly penal statute to corporations which were formed

or availed of for the purpose of avoiding the imposition of surtax upon the shareholders. In the first case which came before this Board under the section as originally enacted (*United Business Corporation of America,* 19 B. T. A. 809; affd., 62 Fed. (2d) 754; certiorari denied, 290 U. S. 635), both this Board and the Circuit Court upon appeal properly stressed the importance of establishing by the evidence the unlawful purpose. It was there pointed out that if such unlawful purpose was shown to exist, then it was immaterial whether the accumulation be large or small. The ultimate question before us, then, is, was there a purpose to enable the shareholder to escape surtaxes. The test, said the Second Circuit Court of Appeals in *United Business Corporation, supra,* is "the state of mind itself, and the presumption does no more than make the taxpayer show his hand." This Board, in the recent case of *A. D. Saenger, Inc.,* 33 B. T. A. 135; affd., 84 Fed. (2d) 721; certiorari denied, October 12, 1936, added that "the display of that 'hand' does not relieve the taxpayer if it discloses the state of mind the statute condemns."

The inquiry as to whether there has been an accumulation of surplus beyond the reasonable needs of the business is not determinative of the ultimate question to be decided. Even if the evidence be sufficient to show that there was an unreasonable accumulation—which, however, I do not believe has been shown in this case—this merely raises a rebuttable presumption of the existence of the crucial purpose. Such presumption is overcome by the evidence in this case which shows an absence of such purpose. The corporation merely continued its long established practice of "ploughing its earnings back into the business." Indubitably it had in the earlier years no "purpose of

preventing the imposition of the surtax upon its shareholders", for there was no surtax to escape. There had been no "sudden change of policy, coincident with large increases in the surtax rates, (which) might * * * betray a purpose to accumulate against a season more propitious for distribution." (*United Business Corporation, supra.*) It had pursued the same policy throughout the years.

In *Cecil B. DeMille,* 31 B. T. A. 1161, 1174 (on appeal to the 9th Circuit), the facts made a much stronger case for the respondent than the facts before us here; but it was pointed out that the taxes and penalties prescribed by the section "are not imposed because of effects; avoidance *per se* is not prohibited. It is the *purpose,* the intention motivating a course of conduct which is made controlling by the very words of the statute. Unless the *purpose* was to prevent the imposition of surtaxes, the tax may not be imposed." This language was recently quoted and reaffirmed by the Board in *Sauk Investment Co.,* 34 B. T. A. 732, 738, and in the very last case which we decided under this section, *Almours Securities, Inc.,* 35 B. T. A. No. 11, the Board said, "There must be such an intent on the part of those who were responsible for the organization of the corporation, or for the conduct of its operations." In the *DeMille* case it was pointed out that the proof went well beyond mere denial of prohibited intent and showed affirmatively a plan necessitating the accumulation of earnings and "the end to which they might ultimately be used." The same, or stronger, language might be used here.

No case has come before the courts or this Board where a corporation engaged in a mercantile or industrial activity, organized prior to the enactment of the income tax law and which has con-

sistently followed the policy of "ploughing its earnings back into the business", has ever been required to pay the tax and penalty imposed by the section in question. In practically every case in which such penalty has been imposed, a large portion of the corporation's assets had been conveyed to it at the time of its formation, or at a later time, by the principal stockholder or stockholders, or the corporation was "a mere holding company." Typical cases are the following: *United Business Corporation of America, supra; United Business Corporation of America,* 33 B. T. A. 83 (reversed on stipulation of the parties); *Keck Investment Co.,* 29 B. T. A. 143; affd., 77 Fed. (2d) 244; certiorari denied, 296 U. S. 633; *William C. DeMille Productions, Inc.,* 30 B. T. A. 826; *Cecil B. DeMille, supra; Fisher & Fisher, Inc.,* 32 B. T. A. 211; affd., 84 Fed. (2d) 996; *Irvington Investment Co.,* 32 B. T. A. 1165; *A. D. Saenger, Inc., supra; R. & L., Inc.,* 33 B. T. A. 857; affd., 84 Fed. (2d) 721; certiorari applied for September 21, 1936; *Edward G. Swartz, Inc.,* 33 B. T. A. 355; *Rands, Inc.,* 34 B. T. A. 1094; *Almours Securities, Inc., supra.* There is a substantial difference between the two classes of corporations, although I would not go so far as to say that the former could never be subjected to the penalty.

This being a "fact case", it is with some reluctance that I reach a conclusion at variance with that of the Member who heard the testimony of the witnesses and had the advantage of observing their manner and demeanor while testifying; but I feel that the evidence is not sufficient to justify the imposition of the penalty and accordingly I dissent.

STERNHAGEN, ARUNDELL, MURDOCK, LEECH, ARNOLD, and DISNEY agree with this dissent.

[SEAL]

Decision.

UNITED STATES BOARD OF TAX APPEALS

WASHINGTON

NATIONAL GROCERY COMPANY, Petitioner, v. COMMISSIONER OF INTERNAL REVENUE, Respondent.	DOCKET No. 76900.

Pursuant to the determination of the Board, as set forth in its report promulgated December 9, 1936, it is

ORDERED and DECIDED: That there is a deficiency of $477,360.68 for the fiscal year ended January 31, 1931.

Enter:

(Signed) CHARLES P. SMITH
Member.

Entered Dec. 10, 1936.

Filed Jan. 5, 1937
U. S. Board of Tax Appeals

Petition for Review and Assignment of Errors.

IN THE UNITED STATES CIRCUIT COURT OF APPEALS

FOR THE THIRD CIRCUIT

NATIONAL GROCERY COMPANY, body corporate, Petitioner on Appeal, vs. THE COMMISSIONER OF INTERNAL REVENUE, Respondent.	B. T. A. No. 76600.

To the Honorable Judges of the United States Circuit Court of Appeals, for the Third Circuit:

Now comes NATIONAL GROCERY COMPANY, a corporation organized and existing under the laws of the State of New Jersey, and respectfully shows and charges as follows:

I

JURISDICTION

That the petitioner on review is National Grocery Company, a New Jersey corporation.

That the respondent on review is the Commissioner of Internal Revenue.

The petitioner filed a United States income tax return for its fiscal year ending January 31, 1931, and paid income taxes shown to be due thereon aggregating $103,616.60.

This is a proceeding for review by the United States Circuit Court of Appeals for the Third Circuit of the order and determination of the United States Board of Tax Appeals of December 9, 1936, which held that your petitioner was liable for a deficiency income tax for the year aforesaid of $477,360.68, under Section 104 of the Revenue Act of 1928.

Petitioner's tax return was filed in the office of the Collector of Internal Revenue at Newark, New Jersey, and its taxes were paid to such Collector.

Jurisdiction is given to this Honorable Court in this case by United States Code, Title 26, Section 641.

II

Nature of the Controversy

Petitioner, National Grocery Company, was organized in the year 1908 for the purpose of conducting a mercantile and manufacturing business, and has ever since been engaged in said business, and was so engaged during the fiscal year ending January 31, 1931. Petitioner's business was organized by Henry Kohl, its sole stockholder, under whose personal management and direction it has been continuously operated. When the Company was organized it owned and operated three stores, had total assets of less than $39,000, and its capital and surplus aggregated $20,943.46.

From the formation of the Company the policy was followed of keeping all the earnings in the business and expanding the business out of earnings. By adhering to this policy and by careful management, the Company's business was increased steadily and consistently, so that for the year under review the Company owned and oper-

ated 815 stores; its gross sales were in excess of $25,000,000; the merchandise sold cost $20,000,000; it had 2332 employees, who were paid wages of $3,132,891.99; it paid rents of $929,918.70, and it owned and operated in connection with its merchandising business, administrative offices, warehouses, manufacturing plants and apparatus, stables and garages, a large bakery, extensive delivery equipment, store fixtures and furniture, and a miscellaneous stock of merchandise contained in its retail stores and distributing warehouses.

In its income tax return for the year under review the Company reported net taxable income of $863,471.67, on which it paid income taxes of $103,616.60.

This same year, however, the Company's assets, consisting of inventory of merchandise, real estate, and securities in its investment account, depreciated in value in excess of $2,000,000, none of which was written off on the books, or was shown on the income tax return.

The total capital and surplus at the end of the year under review, not deducting any of this depreciation, was $8,909,274.72. That year the Company paid its sole stockholder a salary of $104,000, but declared no dividends.

The National Grocery Company had never financed any of its expansions through the sale of stocks or bonds, and its sole stockholder never contributed any assets of any kind to the corporation, since its organization in 1908, except that in 1911 the Company was merged with the Henry Kohl Company and through that merger acquired three additional stores. From that date the business grew solely from the policy of plowing the earnings back into the business.

Petition for Review and Assignment of Errors.

The Commissioner of Internal Revenue on April 25, 1934, mailed notice to your petitioner of an alleged deficiency in income taxes for the fiscal year ended January 31, 1931. The amount of the alleged deficiency was $477,360.68.

The notice of deficiency had annexed to it a statement, which contained the following:

"COMPUTATION OF TAX.

Net income taxable under section 13 of the Revenue Act of 1928	$863,787.22	
Income tax liability at 12%		$103,654.47
Net income taxable under section 104 (c) of the Revenue Act of 1928	$954,654.62	
Income tax liability at 50%		477,322.81
Total income tax liability		$580,977.28
Income tax previously assessed		103,616.60
Deficiency		$477,360.68

After careful consideration of your protest dated July 19, 1932, and subsequent information furnished this office, the Bureau approves the revenue agent's conclusion that in accordance with the provisions of section 104 of the Revenue Act of 1928 your company has permitted its gains and profits to accumulate beyond the reasonable needs of the business instead of being distributed, which is construed as *prima facie* evidence of a purpose to prevent imposition of surtax upon its stockholders.

The deficiency shown above represents your income tax liability as determined under the

provisions of sections 13 and 104 of the Revenue Act of 1928."

Your petitioner promptly and within the time allowed by law filed with the United States Board of Tax Appeals a petition for the redetermination of the alleged deficiency.

On the trial before the Board of Tax Appeals the petitioner proved by the testimony of two of its officers, and two bankers who were familiar with the business, that the petitioner in the year in question did not have more capital than the reasonable needs of the business required, and that it was a sound policy that year, in the light of the panicky conditions then existing, for the Company not to pay out its moneys in dividends, but to conserve all its resources. The facts concerning the origin, development, growth, and conduct of the business were fully proved by competent evidence, as shown by the record.

The respondent offered no testimony contradicting that of the petitioner, but it did offer in evidence the income tax returns of the petitioner, and of Henry Kohl, its sole stockholder.

In due time after the submission of briefs by counsel for the respective parties, the Board of Tax Appeals on December 9, 1936, filed its opinion and determination holding that petitioner was availed of during the fiscal year ended January 31, 1931, for the purpose of preventing the imposition of the surtax upon its sole stockholder "through the medium of permitting its gains and profits to accumulate instead of being divided or distributed."

Seven members of the Board of Tax Appeals dissented from the opinion of the majority, holding that the evidence was not sufficient to justify the imposition of the penalty upon your petitioner,

pointing out that this is the first case which has come before the courts or the Board where a corporation engaged in a mercantile or industrial activity, organized prior to the enactment of the income tax law and which has consistently followed the policy of "ploughing its earnings back into the business", has ever been required to pay the tax and penalty imposed by the section in question.

This appeal is taken from the whole and every part of the judgment and determination of the United States Board of Tax Appeals aforesaid dated December 9, 1936.

III.

Assignment of Errors.

Petitioner alleges that Section 104 of the Revenue Act of 1928 is unconstitutional, and is not applicable to petitioner, and that the United States Board of Tax Appeals erred in the following respects:

(1) Section 104 of the Revenue Act of 1928 has no lawful application to the income of petitioner, and the determination of deficiency based thereon is contrary to law.

(2) The United States Board of Tax Appeals erred in holding that petitioner was availed of for the purpose of preventing the imposition of the surtax upon its sole stockholder through the medium of permitting its gains and profits to accumulate instead of being divided or distributed, within the true intent and meaning of said statute.

(3) The United States Board of Tax Appeals erred in upholding and affirming the determina-

tion of the Commissioner of Internal Revenue which, while purporting to be based upon the application of Section 194 of the Revenue Act of 1928, presumed, without any real determination, that petitioner during the period in question was formed or availed of for the purpose of preventing the imposition of the surtax upon its stockholders through the medium of permitting its gains and profits to accumulate instead of being divided or distributed, notwithstanding said corporation was, in fact, organized for the purpose of conducting a mercantile and manufacturing business in 1908, and has ever since been and was so engaged during the fiscal year ending January 31, 1931, and during said year operated 815 retail grocery stores, with sales of merchandise amounting to $25,142,537.41, and owned and operated in connection with said business administrative offices, warehouses, manufacturing plants and apparatus, stables and garages, a large bakery, extensive delivery equipment, store fixtures and furniture, and a miscellaneous stock of merchandise contained in its retail stores and distributing warehouses; and the business of the petitioner was not and at no time has been or is a mere holding or investment company, nor have its gains and profits been permitted to accumulate beyond the reasonable needs of its business, within the intent and meaning of said Section.

(4) The United States Board of Tax Appeals erred in holding that the National Grocery Company had "gains and profits" for its fiscal year ending January 31, 1931, when the undisputed testimony showed that the market value of its assets during that year depreciated in value far in excess of the net earnings reported in the income tax return.

(5) The United States Board of Tax Appeals erred in holding that the petitioner's accumulation of earnings was in excess of the reasonable needs of the corporation's business, there being no evidence before the Board to justify such a finding, and, the evidence to the contrary introduced by the petitioner being wholly uncontradicted; neither the Commissioner nor the United States Board of Tax Appeals having made any determination as to the amount of capital and surplus that was reasonably required for the operation, under the existing conditions, of petitioner's business.

(6) The United States Board of Tax Appeals erred in deciding that there was a deficiency of $477,360.68 against the petitioner, since the purported determination by the Commissioner of additional tax against the petitioner was not based upon any lawful determination or finding that petitioner corporation was formed or availed of for the purpose of preventing the imposition of the surtax upon its stockholders, nor upon any lawful determination or finding that petitioner corporation permitted its gains and profits to accumulate beyond the reasonable needs of its business.

(7) The United States Board of Tax Appeals erred in upholding and affirming the action of the Commissioner of Internal Revenue in that the determination of deficiency assumes that the entire net income of petitioner corporation for the period in question, before deduction of income taxes and dividends paid, was accumulated for the purpose of preventing the imposition of the surtax upon its stockholders, notwithstanding the fact that said net income was applied during the said period in part to the payment of income taxes

for the preceding year amounting to $94,588.25, and to the payment of a dividend to shareholders, paid March 17, 1931, amounting to $100,000, and that said corporation was subject to an income tax for the then current year under Section 13 of said Revenue Act at the rate of 12%, amounting to $103,616.60, which was paid.

(8) The Commissioner of Internal Revenue did not, in fact, within the time required by law, make any determination of the essential facts necessary for the determination of additional tax under the provisions of Section 104 of the Revenue Act of 1928, the sixty-day letter or notice of the Deputy Commissioner being issued for the sole and only purpose of preventing the running of the Statute of Limitations, pending action by the Commissioner upon an offer in compromise submitted by the taxpayer under date of December 28, 1933, at the instance and request of the Commissioner.

(9) Section 104 of the Revenue Act of 1928 as construed and applied by the Commissioner of Internal Revenue and by the United States Board of Tax Appeals, is null and void in that it is not a tax on income, within the meaning of the Sixteenth Amendment, but is a direct tax within the meaning of Article I, Section 9, Clause 4 of the Constitution, and invalid as such, not being laid in proportion to the Census.

(10) Section 104 of the Revenue Act of 1928 as construed and applied by the Commissioner of Internal Revenue and by the United States Board of Tax Appeals in its judgment appealed from, conflicts with the Fifth Amendment and is null and void, because the so-called tax is nothing less than the confiscation, by action of the Commissioner of Internal Revenue, of so much of peti-

tioner's property as equals the amount of the tax, there being no standard specified in the statute as to the amount of earnings that a corporation engaged in active business may retain for necessary business needs and reasonable expansion, nor does the statute make any specification as to the amount of distribution of earnings that must be made by a corporation to its stockholders to avoid the imposition of the tax, nor is any method or means or standard stated in the law whereby a taxpayer may determine how his business must be conducted in order to avoid a capricious levying of the tax by the Commissioner of Internal Revenue.

(11) Section 104 of the Revenue Act of 1928 is null and void in that it attempts to repose in the Commissioner of Internal Revenue power to determine in his sole discretion, by standards that he alone sets up, whether or not a corporation is availed of for the purpose of avoiding the imposition of the surtax, in contravention of Article I, Section I, and Article I, Section 8, Clause 1, of the Constitution of the United States.

(12) Section 104 of the Revenue Act of 1928 is null and void in that under the guise of an income-tax law, it permits the taking of petitioner's property, without due process of law within the meaning of the Fifth Amendment to the Constitution of the United States.

(13) Section 104 of the Revenue Act of 1928 is null and void in that it reposes in the Commissioner of Internal Revenue sole power and authority to select from the corporations in the United States that make net income those that, in his sole discretion, and by standards that he alone determines, he will subject to the penalty tax, and those

that he will not, by reason whereof said law is arbitrary, oppressive, inequitable, uncertain, ununiform, confiscatory, and not applicable alike to all corporations throughout the United States, in violation of the Fifth Amendment to the Constitution of the United States.

(14) Section 104 of the Revenue Act of 1928 is in conflict with the Tenth Amendment to the Constitution of the United States, and is null and void in that, under the guise of an income tax law, it confiscates the property of corporations incorporated under the laws of the several States and unduly restricts their natural growth and expansion, whereby there will result a lessening demand for labor, a reduction in the amount of wages paid, a reduction in the amount that otherwise would be paid for the purchase of goods by a growing business, a lessening of local taxes paid, all to the increasing detriment of the public welfare of the several States.

(15) The United States Board of Tax Appeals erred in affirming the action of the Commissioner of Internal Revenue and in making its determination in that said action of the Commissioner and of the Board of Tax Appeals amounted to the imposition of an excessive fine, within the meaning of the Eighth Amendment to the Constitution of the United States.

(16) Section 104 of the Revenue Act of 1928 is unconstitutional and null and void in that it is not levied uniformly on all corporations in the United States, and hence violates Article I, Section VIII, Clause 1 of the Constitution.

(17) Section 104 of the Revenue Act of 1928 is unconstitutional and null and void in that it at-

tempts to vest judicial power in the Executive Branch of the Government, contrary to the letter and spirit of Article III, Section I, Clause 1 of the Constitution.

WHEREFORE your petitioner prays that the judgment and determination of the United States Board of Tax Appeals may be reviewed by the United States Circuit Court of Appeals for the Third Circuit; that a transcript of the record be prepared in accordance with the law and rules of said Court and transmitted to the Clerk of said Court for filing, and that the determination of the Commissioner of Internal Revenue and United States Board of Tax Appeals aforesaid may be reversed and set aside for the reasons aforementioned.

JAMES D. CARPENTER, JR.
Attorney for and of Counsel
with Petitioner.

Dated: January 4, 1937.

STATE OF NEW JERSEY,
COUNTY OF HUDSON, } ss.:

ANNA L. MULLINS, of full age, being duly sworn, according to law, upon her oath deposes and says: I am Treasurer of National Grocery Company, the petitioner in the foregoing petition for review. I have read the same, know the contents thereof, and the matters and things therein contained are true as I verily believe.

This petition is filed in good faith and not for the purpose of delay.

ANNA L. MULLINS

Subscribed and sworn to before me this fourth day of January, 1937.

THOMAS J. BOTTI,
Notary Public of New Jersey.

Service of a copy of the foregoing is hereby acknowledged this 5th day of January, 1937.

MORRISON SHAFROTH,
Chief Counsel
for the
Bureau of Internal Revenue,
Attorney for Respondent.

Statement of Evidence and Exhibits 1-24 Inclusive and "A".

UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT

NATIONAL GROCERY COMPANY, Petitioner, *vs.* GUY T. HELVERING, Commissioner of Internal Revenue, Respondent.	B. T. A. DOCKET No. 76600.

Hearing at New York, New York, on the 7th day of May, 1936, at 10:30 o'clock A. M.

The above entitled cause came on for hearing on this the 7th day of May, 1936, before Honorable Charles P. Smith, Member of the United States Board of Tax Appeals, at New York, New York, pursuant to notice of hearing heretofore given; whereupon the following proceedings were had and testimony heard, to wit:

Appearances:

James D. Carpenter, Jr., Esq. (75 Montgomery Street, Jersey City, N. J.), on behalf of the Petitioner.

Ralph E. Smith, Esq. (Herman Oliphant, General Counsel for the Department of the Treasury), on behalf of the Commissioner of Internal Revenue, Respondent.

Statement of Evidence and Exhibits 1-24 Inclusive and "A".

PROCEEDINGS.

The Clerk: Docket 76600 National Grocery Company.

STATEMENT OF CASE FOR PETITIONER.

Mr. Carpenter: This is a deficiency assessment for $477,360 levied against the petitioner for the fiscal year ending January 31, 1931, under Section 104 of the Revenue Act of 1928, for permitting its gains and profits to accumulate in excess of the reasonable needs of the business, as the government alleges. I don't think you need more than that as a preliminary statement. I should say I have been cooperating with counsel for the government for some weeks in getting the facts in shape for easy presentation. I have prepared a number of schedules of facts from the books and submitted them all to counsel for the government, and while we have not prepared a formal stipulation we have agreed that I shall make certain offers and they will not be objected to. There are some things that they reserve the right to object to as to materiality, and not as to form. I think we can clear the decks rapidly on those formal matters and get down to the taking of testimony.

The Member: Mr. Smith, have you on opening statement to make?

Mr. Smith: Yes, if your Honor please, as counsel has said, this is a case in which a tax is proposed due to the alleged unreasonable accumulation of surplus without making distribution. As I intimated to counsel a moment ago, it is not the intention of the respondent to take much time offering testimony. Our case will be found chiefly

in the schedules of the operations of the National Grocery Company during the year in question and previous years. From that we will ask the Board to make its deductions.

But, at the outset, the Board will get our position more clearly if I state that these figures we expect will show that this business has been eminently successful, and that from January 1, 1913, when the surplus of the company was $70,000, it increased until at the close of January 31, 1931, the year in question, it had a surplus of $8,909,000; and that during that period only $50,000 was declared in dividends. We expect also to show that during the same period or, rather, beginning on January 31, 1931, there were loans from the corporation to Mr. Kohl, who owned practically all of the stock, beginning with $26,000 in 1921 and closing with $610,000 at the close of 1931, and that during that period those loans were made from his corporation to him, part of the time on notes without interest and part of the time on notes specifying interest, but on which he paid no interest to the corporation. That is the high light in this case—those two things. There will be other things that will develop from the stipulations. But that your Honor may see the reasons as the Commissioner sees it for holding that there are unreasonable withholdings from dividend distributions, we mention those things now.

Mr. Carpenter: I did not attempt to give you a recitation of the facts. I think we would perhaps prefer to give you the high lights as we go along and make the offers. You will get our story from that.

The first thing that I offer is a determination by the Commissioner of Internal Revenue that

for the calendar years ending January 31, 1923, and January 31, 1924, this statute, Section 220 of the old act applies and there was unreasonable gain. The proceedings which resulted in a decision by the General Counsel's office, that after a review of the facts there was no such unreasonable gain, were followed by a stipulation on which the Board made its determination of a small deficiency of $9,300 and $10,000, respectively, not under this particular section or under Section 220. I think that goes to show that up to the years in question, that is, 1923 and 1924, the government or this Board determined as late as a judgment of June 12, 1929, that there was no unlawful gain or excessive gain in the surplus.

The Member: But the Board did not make any adjudication of the case?

Mr. Carpenter: No, made by the General Counsel's office, and a stipulation was entered on that opinion. And then the effect of the Board's decision was that there are deficiencies for the fiscal year ending January 31, 1923 and 1924 in the amount of $9,300 and $10,000, respectively. But as to those particular years there was no tax under Section 220.

The Member: The only thing was there was no adjudication of the interest by the Board.

Mr. Carpenter: Except the stipulation of general counsel.

Counsel does not object to the form of the offer, but only as to the materiality.

Mr. Smith: We object to the relevancy and the materiality of this correspondence and these determinations. They involve former years. They are not an adjudication by any tribunal. I think that sufficiently states the position. It has no more bearing or effect on the year in question than a

revenue agent's report would be subject to modification, subject to reconsideration, subject to redetermination. And because the Commission may have made errors in previous years, those errors ought not to be material evidence in this case.

The Member: I agree with you 100 per cent, Mr. Smith. But nevertheless for the purpose of the record I am going to receive the documents that have been agreed to between you, simply for the purpose of completing the record.

Mr. Smith: And they are received only for that purpose?

The Member: Well, I have indicated my thoughts and of course the Board has ruled many times that matters of this sort are not at all binding on the Board. I am really accepting them for the purpose of forestalling any higher courts from saying that I have excluded what the higher courts considered as competent evidence.

Mr. Smith: Then merely for the purpose of protecting the record, from our own standpoint, may we have an exception?

The Member: The exception will be noted. This will be received as Exhibit No. 1.

(The document referred to was received in evidence and marked "Petitioner's Exhibit No. 1," and made a part of the record.)

Mr. Carpenter: I now offer in evidence a determination by the Commissioner that Section 220 was applicable to this corporation for the fiscal year ending January 31, 1928, and the determination of the Deputy Commissioner on October 13, 1930—the taxable year in question—that after carefully considering the facts contained in the protest and additional facts disclosed at the hear-

ing April 25, 1930, before the office of the General Counsel, "the protest is sustained and accordingly it is held that your company is not subject to taxation for the fiscal year ending January 31, 1928, under Section 220 and 104 of the Revenue Acts of 1926 and 1928,"

I may indicate to you that so much of this statute operates upon the intention and purpose of the taxpayer that I think it is quite material for us to make that showing.

Mr. Smith: Can we make the same objection as previously made to Exhibit No. 1?

The Member: Yes. And the record will show an overruling of the objection and exception noted. The paper will be received in evidence as Petitioner's Exhibit No. 2, merely for the purpose of completing the record.

(The document referred to was received in evidence and marked "Petitioner's Exhibit No. 2," and made a part of the record.)

Mr. Carpenter: I am making only the offer of one copy. How many additional copies should I file?

The Member: That is all that is necessary, in exhibits.

Mr. Carpenter: I now offer in evidence the certified copy of the certificate of incorporation of the National Grocery Company and the amended certificate. It was originally incorporated according to the certificate on June 2, 1908, with an authorized capital of $5,000 divided into 50 shares of par value of $100. each.

And then in the year 1911, that certificate was amended and increased the capital stock to $200,000 authorizing it generally to do a grocery business.

Statement of Evidence and Exhibits 1-24 Inclusive and "A".

The Member: Without objection that is received in evidence as Petitioner's Exhibit No. 3.

(The document referred to was received in evidence and marked "Petitioner's Exhibit 3," and made a part of the record.)

Mr. Carpenter: I now offer in evidence a table which is made up from the books which I have shown to government counsel and changed somewhat to meet their views, and this shows that the year 1908 to January 31, this year, inclusive, every year—these items: First, the number of stores in operation. And right here I may indicate to your Honor this fact, that this is the first case that to my knowledge has been tried where the taxpayer tried under this section was a real business enterprise, incorporated long before the statute or any income statute was passed and I cannot ever say it was formed for the purpose of evading taxes. This is a corporation which, through active actual business operations and through accumulating its surplus, keeping all its earnings in the business, having nothing added to it by way of additional capital or securities deposited with it, had actually grown from three groceries in 1908 to 815 grocery stores at the end of the taxable year in question, through the principal, the only stockholder, Henry Kohl, leaving in the business its earnings and profits, and drawing just enough for his own personal needs, the business grew to those proportions.

Its net profits in that time grew from $4,500 per annum to the taxable year in question when they were $682,000, as apparent by the statement made up according to the income tax laws.

But we will show you as we go along that at the end of that year, the corporation was in worse condition than it was at the beginning of the year because of the depreciation in inventory, in property, and particularly in the securities that it had bought out of its accumulated funds. So that while we show an apparent net addition to capital and surplus for that year of $682,000, we will show you as we go along that the depreciation was far in excess of that.

This statement, among other things, shows that Mr. Kohl's total salary, withdrawn from this business, from 1908 to the year 1930, the end of that year, was $1,026,000. The total Federal tax paid by the corporation in that same period was $1,842,000. The total net profits, per the books, was $8,085,000. The net additions to capital and surplus were $8,035,000. The other taxes they have paid to the state and municipalities aggregated $472,000.

Mr. Kohl's personal income taxes which he paid aggregated $109,815. Those figures I gave you were the totals according to this statement at the end of the fiscal year 1932. From that date on down to this date the total salary drawn by Mr. Kohl was $1,424,000. The total Federal taxes paid were $1,900,000. The net profits as per the books were $9,400,000. I am leaving out the odd figures. The total dividends declared from the beginning of the corporation to date were $850,000. The net additions to capital and surplus were $8,576,000. The total other taxes, real estate, personal and so forth paid by the corporation were $816,000. Total personal income taxes paid by Mr. Kohl, $407,000.

The recapitulation shows that the total taxes paid to the government by Mr. Kohl on the busi-

ness aggregated $2,367,000, whereas the total he withdrew from the corporation in salaries and dividends is $2,200,000—or an excess in taxes paid of $100,000.

Mr. Smith: If your Honor please, at this time the respondent objects to so much of this exhibit as appears subsequent to the close of the year January 31, 1931, for the reason that it is immaterial and irrelevant to the issues in this case. We contend that which took place subsequent to this year in question can have no bearing on the intent of Mr. Kohl or the National Grocery Company, either as to the distribution of dividends or otherwise, as far as the year in question is concerned. It can have no bearing on unreasonable accumulation of surplus for the year in question. For that reason we object on the ground that it is incompetent, irrelevant and immaterial—all that appears on here with reference to what took place subsequent to January 31, 1931.

The Member: That is the only portion of the exhibit you are objecting to and you are objecting to it only on the ground that it is incompetent.

Mr. Smith: On the grounds stated, as having no bearing either on his intent or the unreasonableness of the accumulation prior thereto.

The Member: For the purpose of the record the objection is overruled and the document is received as Petitioner's Exhibit No. 4.

(The document referred to was received in evidence and marked "Petitioner's Exhibit No. 4," and made a part of the record.)

The Member: I agree with you, Mr. Smith, however, upon your statement of the case. I feel personally that it does not have any bearing.

Mr. Smith: May we have an exception?

The Member: Exception noted.

Mr. Carpenter: I now offer exhibit prepared by the government. This shows an analysis of the surplus. We have checked it and find it accurate and as I have agreed with Mr. Smith to have the entire picture before you to present this in its present form.

The Member: Received as Petitioner's Exhibit 5.

(The document referred to was received in evidence and was marked "Petitioner's Exhibit No. 5," and made a part of the record.)

Mr. Carpenter: I now offer in evidence a copy which happens to be a photostatic copy of the balance sheets of this corporation for the year ending February 1, 1908—the fiscal year—is that the date —to the fiscal year ending January 31, 1936, giving all of the figures on the balance sheets as per the books. There will be found to be a slight difference between the surplus shown on this balance sheet and the surplus shown on the government statement which I have just put in, but I will have that explained by verbal testimony of witnesses later on. This, I may say to your Honor, pretty clearly shows the growth of this business through the policy that was adopted by Mr. Kohl over the years that he has operated it.

I have submitted this likewise to government counsel and I think they have agreed.

The Member: Received as Petitioner's Exhibit No. 6.

(The document referred to was received in evidence and marked "Petitioner's Exhibit No. 6," and made a part of the record.)

Mr. Smith: Now, we, the respondents, object to so much of this exhibit as relates to the years subsequent to January 31, 1931, on the ground that it is incompetent, irrelevant and immaterial.

The Member: Objection overruled and exception noted.

Mr. Carpenter: I now offer in evidence a statement showing these facts from the year ending January 31, 1908 to January 31, 1936. It shows these figures:

The number of stores operated, the increase or decrease over the preceding years, the gross sales per annum, which I may say to your Honor ran from $181,000 in the year 1908 to $25,142,000 in the year 1930—the year in question. It shows the net profits per the books as net taxable income for each year. I may point out that for the last four years the statement shows that the net profit, net taxable income as shown, is as reported on the Federal income tax returns filed. They have not yet been audited by the government.

Mr. Smith: We make the same objection as previously made with reference to the years subsequent to January 31, 1931.

The Member: Objection overruled and exception noted. It will be received as Petitioner's Exhibit No. 7.

(The document referred to was received in evidence and marked "Petitioner's Exhibit No. 7," and made a part of the record.)

Mr. Carpenter: I now offer a statement which has been prepared from the books, at the request of the government, to show this information: For the years ending January 31, 1926 to date, the number of stores opened per annum, the number

of stores closed, the net increase or decrease, and the number of stores in operation at the close of the fiscal year. Counsel for the government has some reason for asking for that information and we have procured it.

The Member: It will be received and marked Petitioner's Exhibit 8.

Mr. Snith: I make the same objection with reference to all of those years subsequent to January 31, 1931.

The Member: Objection overruled and exception noted.

(The document referred to was received in evidence and marked "Petitioner's Exhibit No. 8," and made a part of the record.)

Mr. Carpenter: I now offer a statement showing the number of employees at the National Grocery Company for the years 1924 to date and the total wages paid the employees per year, which shows that for the year in question the number of employees was 2,332 and the total wages paid was $3,132,891.

Mr. Smith: We make the same objection with reference to those years subsequent to January 31, 1931.

The Member: Objection overruled and exception noted. It will be received as Petitioner's Exhibit 9.

(The document referred to was received in evidence and marked "Petitioner's Exhibit No. 9," and made a part of the record.)

Mr. Carpenter: I now offer a sheet showing the purchases, the discounts and the rents paid by the National Grocery Company for the years

ending January 31, 1926 to date, which show for the calendar year in question, for instance, that the purchases of merchandise for that year were $19,993,937; the discounts taken by the corporation by the use of its capital in discounting bills, which by the way paid taxes, were $493,719. The total rents paid on rented store properties $929,918.

Mr. Smith: I make the same objection with reference to the subsequent years beyond January 31, 1931.

The Member: Objection overruled and exception noted. This will be marked Petitioner's Exhibit 10.

(The document referred to was received in evidence and marked "Petitioner's Exhibit No. 10," and made a part of the record.)

Mr. Carpenter: I now offer in evidence a statement that was prepared at the request of counsel for the government showing the loans made by the corporation to Mr. Henry Kohl, the sole stockholder, on which no interest was ever paid, shows no interest was ever paid, charged or accrued on the books. That from 1922 down to date. And I call the Court's attention to the fact that although for the year 1930 Mr. Kohl borrowed $140,000 on notes, those were all paid as shown on this statement at various times since out of his earnings.

Mr. Smith: No objection to that.

The Member: Received as Petitioner's Exhibit 11.

(The document referred to was received in evidence and marked "Petitioner's Exhibit No. 11," and made a part of the record.)

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Mr. Carpenter: I now offer in evidence a statement prepared for counsel for the government showing the application of the dividends received by Mr. Kohl to various amounts and how those dividends were paid. They were all paid by checks excepting a dividend that was declared on March 23, 1931, and that dividend was paid, $40,000 by check and $60,000 by a book entry which credited notes receivable by $60,000 on March 20th and the $40,000 check was given on March 17, 1931.

There is a difference, you will see. The statement shows the dividend was declared on March 23rd, whereas the check was given March 17th for $40,000 and the credit was on March 20th. But later on I will show what actually happened. It was done pursuant to instructions issued and not approved, really, until a later meeting.

The Member: Received as Petitioner's Exhibit 12.

(The document referred to was received in evidence and marked "Petitioner's Exhibit No. 12," and made part of the record.)

Mr. Carpenter: I now offer a statement showing basis for the insurance reserves for the year ending January 31, 1931. I call your Honor's attention to the fact that on the balance sheet which shows that the corporation carried reserves for insurance starting some years ago. In other words, they become self-insurers for certain lines of insurance and credited to that reserve account the premiums charged by the straight line insurance companies for the kind of insurance they self-insured. This statement shows that for the year in question, 1930, they carried self-insurance

on 800 stores—fire, merchandise and fixtures, public liability and property damage, fidelity bonds, burglarly on merchandise and cash, hold-up, plate glass, forgery; carried self-insurance on motors against burn-outs and mechanical accidents and full coverage collision on all of their automobiles.

They carried their own sprinkler leakage insurance on 300 Mercer Street (their office building), and insurance on merchandise in transit. This, in other words, states the total. This is the insurance they would have paid to other companies had they not self-insured.

The Member: Received as Petitioner's Exhibit 13.

(The document referred to was received in evidence and marked "Petitioner's Exhibit No. 13," and made a part of the record.)

Mr. Carpenter This business, if your Honor please, from time to time has borrowed money from banks. Here is a schedule I have had made up from the books showing notes payable from the business from January 24, 1925 to date and showing the rate of interest charged by the banks on these notes. This was prepared at the request of the government.

The Member: Received as Petitioner's Exhibit 14.

(The document referred to was received in evidence and marked "Petitioner's Exhibit No. 14," and made a part of the record.)

Mr. Carpenter: I now offer a schedule of the securities holdings of this corporation as shown in the balance sheet in totals as of January 31, 1930 and January 31, 1931. The schedule shows

the individual security, the number of bonds or stocks held, the market price on January 31, 1930 and on January 31, 1931, the beginning and end of the year, and the cost prices at the beginning and end of the year, there being some additions during the year by way of purchase or sale. This has been submitted to the government and they have checked it completely, but they have—but they are not satisfied with a few of the market prices we have there. Mr. Kohl, for instance, bought stocks in Jersey City banks where he had been doing business for years. There is quite a difference between the price that the government put on one or two of those stocks and ours. Ours are taken from the dealers and obtained by the dealers of securities who appraised them in Jersey City—specialists in those securities, and their man will be here later in the day to testify and to substantiate these prices. I may say that this schedule shows that for the taxable year in question the depreciation in the value of these securities between the beginning and the end of the year was $943,517.42, or a sum in excess of the apparent net earnings of the business for that year.

The Member: Are you objecting to that exhibit, Mr. Smith?

Mr. Smith: No.

The Member: It will be received in evidence as Petitioner's Exhibit 15.

(The document referred to was received in evidence and marked "Petitioner's Exhibit No. 15," and made a part of the record.)

Narrative statement of the testimony produced before Honorable Charles P. Smith, Member of

the United States Board of Tax Appeals, taken at New York, May 7, 1936.

Twenty-four exhibits were offered in evidence by the petitioner, marked 1 to 24, respectively.

Eleven exhibits were offered in evidence by the respondent, marked A to K, inclusive.

Mr. Henry Kohl, a witness on behalf of the petitioner, being duly sworn, testified: I am sixty-five years of age, was born in Germany, and came to America in 1887, without any money or property. I first entered the grocery business as a clerk in Brooklyn, and went to Jersey City in 1889, where I was employed as a clerk in a grocery store. In 1891 I bought one store for $500. I had saved $217 during my time as a clerk, and persuaded a friend to go into the business with me; together we paid $250 in cash and $250 in notes for the store, and what little cash we had left over was our working capital. The store was in a poor section of Jersey City and I looked about for another store, and bought a second store for $250 gross, paying $125 in cash and $125 in notes. My partner ran one store and I ran the other. The partnership was unsatisfactory, so the partnership split, I taking one store and my partner the other.

By 1900 I had purchased two stores in my own name. At this time I did business like all other stores, except that I gave trading stamps to my customers. I was the first man to use trading stamps in grocery stores. I delivered goods on credit, made deliveries to purchasers, and in short did business like all other grocers. I had very few friends who were willing to stick to me or help me. During my early years I lived in the back of the store, cooked my own meals, and lived "like all poor devils do." Some times I had

credit and other times I had no credit. "If I was overstepping myself, naturally my credit was not so good. If I was keeping in a shell, naturally my credit was good." I drew from the business in the early years nothing but a bare living.

In 1906 I had three stores and that year formed Henry Kohl Company, a New Jersey corporation, and did business under that name until 1911.

In 1908 the Henry Kohl Company lost $4,000. Its assets were about $20,000 at the beginning of the year, and only $16,000 at the end of the year. Because of the trading stamps and selling on credit, I was going backward and was needing money. I worried very much because I worked very hard. "I prayed awfully hard—until I got this idea of the cash and carry stores, which was the original idea in the United States." After getting the idea of the cash and carry store, I opened one store as an experiment in Jersey City under the name of National Grocery Company. The difference between that store and the stores owned by the Henry Kohl Company was the way I handled merchandise. There was a lot of dishonesty in the grocery business prior to that time, and people never got what you call a square deal in a grocery store in regard to coffee, butter, spices, extracts, etc. They were adultered, were sold from old tin cans; extracts were adultered; coffee was largely chickory; goods were sold on credit, and my losses were large. When I opened my first cash and carry store I handled nothing but the best merchandise. I handled nothing but pure spices, coffee, extracts, etc., and put them in nice little tin cans. I sold only one price coffee, and that to the rich and poor alike, seventeen cents a pound, three pounds for fifty cents. "There

is not a pound of chickory sold in the United States as coffee because I threw it out."

In the cash and carry stores the goods were so arranged that clerks could handle them quickly and wait on customers quickly. I did away with chairs in front of the counters; I did away with telephones and taking orders. A woman came in, bought merchandise, paid the price, and took it away with her.

The cash and carry store business was new and it took the women sometime to get the idea. My idea was that a woman who paid cash and was willing to take the goods home was entitled to a cheaper price. Then people who bought in the cash and carry stores saved almost fifteen per cent as against buying in the old time stores. Fifteen per cent was the difference in overhead between the old time stores and the cash and carry stores.

After about six months the first cash and carry store began to do a great deal of business. I then opened two additional cash and carry stores under the name of National Grocery Company, and in 1908 incorporated this business into the National Grocery Company. At the same time my three old stores were running under the name of Henry Kohl Company.

In 1911 I merged the National Grocery Company and the Henry Kohl Company under the name of National Grocery Company. After this merger I had fifty-seven stores. It is quite a question how I financed the additional stores. I did it by using all of the money that I could borrow and what little money I made in profits. I never sold any stock or bonds. In the early days I tried to sell stock or bonds in Wall Street, but I was not

welcome there and was unable to raise any money by that kind of financing. As time went on and by the method of keeping all of my profits in the business, except what were necessary for my bare living expenses, "I was independent and did not want to sell it." In the early years I needed very little money and drew very little money out of the business, and confined my drawings to my bare living expenses.

About 1911 or 1912 I purchased a lot on Montgomery Street, Jersey City, and later erected a warehouse for the uses of the business. A year or two later I bought a stable to house the horses and wagons used in the business. These buildings are still in use by the Company.

I expanded the business year by year, really quicker than I could afford, and financed the expansions with the profits I made from year to year, leaving them right in the business. During the War years the business increased slowly, because I was advised that it was contrary to the policy of the Government to expand this kind of business, and I was encouraged not to invest money in expansion. It was the policy to invest money in Liberty Bonds, and I did that and did not open any stores. The Government wanted everything confined to War activities, rather than the expansion of private business.

About 1915 the National Grocery Company erected a bakery to bake the bread that it sold in its stores. About the same time also the National Grocery Company built a garage next to the bakery. These were located at Montgomery and Mercer Streets, near the old warehouse to keep the business centralized. I have tried several times to buy an adjoining lot for expansion purposes, but the owner would not sell it to me.

The buildings aforementioned front on Mercer and Montgomery Streets, Jersey City, and occupy a large part of the block between those streets. Since the bakery was completed it has supplied all of the bread and a large part of the cakes that we have sold in our stores. At one time we sold as high as forty thousand loaves of bread a day. This was before the depression. At this time we sell about twenty thousand per day. At this time we are putting in all new machinery in the bakery at an expense of about $150,000. It will aggregate that when we are finished.

In 1923 the National Grocery Company built an additional warehouse and office building on Mercer Street, across the street from the old warehouse building. We had plans drawn for a ten story building, but when we received estimates of the cost, we found it would cost too much money, and I had the plans drawn for a six story building, which was promptly erected.

The National Grocery Company had in mind opening more and more stores. I always had great big ideas. To carry them out is another question. We wanted more stores, naturally. Our system was right and the public wanted them, but we could not carry it out all the time. Competition came, but we wanted plenty of stores. We had to have a certain amount of capital in order to have credit. Your credit depends on your statement. "If you don't have a decent statement you cannot buy your merchandise right or do anything right." The National Grocery Company had to buy large quantities of merchandise all the time. Ever since we have been able to discount our bills we have been doing it. It is a very important thing in our business to get the discounts

and pay cash for merchandise. That is the inner profit of the business.

For the year 1930 the discounts amounted to $434,000. The purchases for that year were in excess of $19,000,000, and the discounts were almost two per cent of that figure. In order to make those purchases and take our discounts we had to have large capital.

It has always been our policy to rent our stores and not own the real estate on which they are located. All of the eight hundred odd stores that we had in 1930 were rented, except one. The rents were payable monthly in advance, and the leases were not long. Years ago we had very long leases, but lately we do not take long leases. Of recent years we have taken one year leases, with the privilege of three or four years' extension, at our option.

We have a building called the return building located on Mercer Street, to which we take all of the "returns" from the grocery stores. I am the originator of this idea connected with the grocery business. Years ago the grocery men used to give away boxes or sugar barrels, etc. I clean my stores out twice a week, so that the stores are kept clean of rubbish. That is returned to the return room and separated, and the bags, barrels, etc. are sold. This might be called a salvage department, and its operations have increased our profits considerably.

In 1930, as well as at this time, there has been little change in the cost of opening stores. Fixtures these days are high. We are spending a lot more money than we used to. The cost is $2200 to $2500, maybe more, per store. We have to have $400 or $500 cash to run the store—cash in bank,

and including everything you have to have about $5000 per store.

The manager in each store deposits the money in bank every day. We carry one hundred or more bank accounts, in which our receipts are deposited. Our eight hundred stores serve an area within a radius of fifty-five miles, located in the northern part of New Jersey. We have about thirty stores in Staten Island, New York, and some in Nyack, but none in New York City. We have several times made surveys with the idea of opening stores in New York City, and it is our intention to come into New York City. We have had stores in the past in New York and closed them up because they were in bad locations and did not turn out right. I cannot remember the years we closed these stores. In the last two or three years we have had surveys made in New York, with the intention of opening additional stores, but have not done it. Within three years we had the Noyes Company getting us locations. We were not able to find the right sections for our stores. It is very hard.

We have also been on the lookout at all times to try to buy chain stores, but it has not happened. Sometimes it was because they were poor—run down; other times, too high in price. As late as last year we had a large chain of stores offered us for purchase, but did not buy because they did not show a very good investment. We had the money available, but refused to buy because the stores offered were not in a healthy condition, and I did not think it a good thing.

I do not think that in the year 1930 we had more capital and surplus in the business than the business required.

Statement of Evidence and Exhibits 1-24 Inclusive and "A".

In 1929 and 1930 Mr. Bohack of the H. C. Bohack Company in Brooklyn, was alive, and offered to sell me his chain stores, consisting of five or six hundred stores. I considered seriously purchasing a part, if not the whole of the business. We made a careful survey of this business to see if it was profitable for us to buy it, but while the negotiations were pending he became ill and died. These negotiations were resumed as late as last year. The Bohack Company is a large concern. I would not be surprised that it is five or six million dollars.

I borrowed during the fiscal year ending January 31, 1931, from National Grocery Company the sum of $140,000, in sums of $40,000 and $100,000. My health was poor that year and I bought a Winter home in Palm Beach, Florida, and borrowed $40,000 from the National Grocery Company to make the purchase at that time. The sum of $100,000, which I borrowed on January 31, 1931, I used to pay off a loan of $100,000 to the Commercial Trust Company, which money I had borrowed to make a payment of $100,000 to the Jersey City Young Women's Christian Association. The circumstances were as follows:

In 1929 or 1930 the Young Women's Christian Association in Jersey City were constructing a building, and I talked with one of the members of the firm of Colgate & Company about the completion of that building. We had a campaign on and were short of funds. The Colgates wanted me to give as much as they gave. I was in charge of the campaign and I wanted to see the women get the money necessary to complete the building. We were short a couple of hundred thousand dollars, and I told Colonel Colgate that if he would give

half I would give half, so that the women would have the money.

I borrowed $140,000 from the National Grocery Company in the fiscal year 1930, instead of declaring dividends, because it was temorary borrowing, and I expected soon to pay it back. I paid back $100,000 within three months.

I offer in evidence the following promissory notes, all of which were given to National Grocery Company for borrowed money, all of which are paid and cancelled:

July 3, 1928, a note payable to the order of National Grocery Company, on demand, for $15,900; note dated December 26, 1928, for $10,000; note of $10,000, dated December 17, 1929; note dated April 21, 1930, for $30,000, payable on demand; note dated June 16, 1930, for $10,000, payable on demand; note for $100,000, dated January 9, 1931; note dated March 17, 1931, for $40,000; note dated March 15, 1932, for $25,000. All these notes were paid to the National Grocery Company on the dates written on the notes in blue pencil. The statements in evidence show how and when they were paid and from what sources.

In August, 1932, I borrowed $65,000 from the Hudson County National Bank, Jersey City, on my promissory note, and renewed that, month by month, until December, 1932. The day I borrowed this $65,000 from the Hudson County National Bank I paid that amount on account of my loans to the National Grocery Company.

In 1930 general business conditions that year were not good. Everybody knows that. The value of assets that year in every business was shrinking. Our merchandise inventory, and everything else, was going down. Everything

was declining in value. The reason I borrowed from the Company was because I expected to pay it back, and it was the quickest way I could get the money I needed. I have always been proud of the statement of the National Grocery Company and I was very careful not to injure it at any time. If I borrowed the money from the Company and gave it my note, it would not have any effect on the Company's statement, whereas if I declared a dividend, the money would go out of the Company. I kept all the earnings in the business because "I needed them in the business —always needed them in the business. I never had any too much money in my business. That was my judgment." The construction of the buildings and the bakery was all financed out of the earnings of the business. Even with all the capital that the Company had we had to borrow money from the banks occasionally as it was needed. We needed it to buy butter and eggs and put them in storage, and to buy merchandise when it was the right time to buy. Frequently you need more money that you have got. It takes all of the money we have got to swing that. We buy butter every day, but in June we buy butter for the next Winter.

"Q. How about coffee—do you buy that in large quantities? A. That all depends.

Q. On what? A. If war were declared tomorrow we would buy a year's supply and would be fortunate to have the money to do it with.

Q. How about sugar? A. Well, sugar, too. Years ago we had the same thing. Ordinarily we don't buy it that way—we buy it regularly.

Q. Do you buy any merchandise abroad? A. Not very much—no.

Q. But you hold yourself ready with the cash to buy if necessary a whole year's merchandise if you think you can make money by doing it? A. Certainly, at all times.

Q. And in your judgment do you have to be in that position to be able continuously to supply 800 stores with merchandise? A. Well, the more money you have got the cheaper you can buy and the more independent you are and the more you are recognized—and everything depends upon your statement."

It has been the habit with us to keep in the business every possible dollar, and let that accumulate for the benefit of the business. I think it is good business judgment and I guess everybody else does. The bankers tell you that. If we had adopted a different policy and in the good years from 1920 to 1930 had drawn out of the business a large part of our profits, I do not think we would have been able to withstand the effect of this depression the way we have. I think those concerns who did do that have gone.

Cross-examination:

At the close of January 31, 1931, I owed the Company $610,000. I do not remember when I began borrowing from the corporation. I do not know whether I paid back the first loan. I do not know whether any loan that was made prior to January 1, 1931, had been paid before January 31, 1931: I do not remember whether I paid interest on my loans. I think some notes bore in-

terest and some did not. I do not know why they did not bear interest. I do not know why if the corporation needed the money I did not pay interest. I do not know if it needed the money. Then we needed the money for expansion. I do not know why I did not pay the notes in full. I do not remember whether the Company was borrowing from the banks in 1929. When I borrowed money from the banks I paid interest. When I borrowed the $140,000 from the corporation in 1930, I do not know if I claimed as a deduction in my income tax return a contribution to charity.

I made a survey for the extension of our business of chain stores in New York about fifteen years ago. We closed up the stores about a year after we opened them. I did not make another survey in New York until about three years ago, but we opened stores right along in Jersey.

The assets of the National Grocery Company began to decline in 1931—I guess in those days after '29. Up to '29 there had been a gradual increase in value. I declared no dividends then. After 1931, or '29, I declared no dividend. We declared a dividend in 1932.

"Q. So that as far as your business is concerned, the increase in value of your assets and the decrease in value of your assets had nothing to do with your declaration of a dividend? A. Practically speaking, no.

Q. What was there about your business that would lead you to declare a dividend in 1932 rather than prior to January 31, 1931? A. I think it would be advice of counsel, no doubt.

Q. Now, in 1933 there was a declaration of a dividend of $100,000; in 1934, another

dividend of $100,000; and in 1935, $200,000; and in 1936, $200,000. Now, what was there about your business in those years that led you to declare those dividends? A. Well, in the first place we could afford to pay a dividend.

Q. But three years ago you were planning an extension of your business and you were making surveys, is that right? A. Yes.

Q. And yet you were declaring dividends of $100,000 and $200,000. A. Well, we didn't spend anything. We could afford it.

Q. Couldn't you afford it in 1929? A. I do not think we could afford it in 1929."

Our sales were greatest in 1929 or 1930. Our book accounts were greatest in the years we did the most business.

Re-direct:

I did not refrain from paying dividends in the National Grocery Company in 1930 in order to avoid the payment of any government taxes. I have never done that.

"The Member: I notice from one of the exhibits here that the corporation had on hand investments in stocks and bonds on January 31, 1931, which cost the corporation $2,989,000 odd. Why did the corporation make investments in all those different kinds of stocks and bonds?

The Witness: To invest that money so that when we would need it we would have it. All corporations do that more or less. * * * We wanted to use it all the time. It was invested because we wanted to have the cash on

hand. And those were the days there was very little investment. We had to have the money ready. What will you do with it if you don't invest it? * * * It was part of our business. We carried that money, of course, principally to have the money on hand and get something for it. At the banks you would only get 2 per cent at that time. Of course, you don't get anything now. So we bought some stocks and bonds which we could turn over. You know, you can turn that stuff over in the morning, in a couple of hours, and you have your money if you want it."

The money was invested that way so that whenever we needed the money we could sell the securities and get the money. All corporations do that.

Re-cross:

I do not know whether the securities were ever pledged as collateral on our loans from the banks, but they always showed as a credit on the Company's statement. The credit of the Company was not always good. I do not know whether in the years from 1925 to 1931 we had to place any of our securities as collateral with the banks; I don't think I did.

Re-direct:

The credit of the National Grocery Company was always good according to my opinion, but not to the other fellow. In the early years when we went to the banks to borrow money I had plenty of difficulty in getting credit. I found from actual experience that having those securities in

the statement of the National Grocery Company enabled the Company to get credit at low rates where we had been unable to do that in the earlier years.

Anna Mullins, a witness on behalf of the petitioner being duly sworn testified:

I am Treasurer of National Grocery Company and have been associated with that business and with Mr. Kohl since 1897. At that time he had one store.

A comparison of the built-up balance sheets from the beginning to date, when compared with the statement of the surplus that the Government prepared, shows a difference which is principally taken care of by the adjustments that were necessary after an examination of our returns. For instance, the insurance that we had charged to our expense account was disallowed, and the income tax reserve that we had charged to taxes was disallowed, and any other minor adjustments, like prepared payrolls. Those were the only ones. The built-up balance sheet is per our books, and the other is per the tax return after the audit.

It has been Mr. Kohl's policy from the formation of the business that he could make more money by reinvesting the earnings in the business than in any other type of investment. The reason the National Grocery Company invested money in a diversified list of stocks and bonds, was because the cash was always available when it was invested in that type of securities and meanwhile was earning money. The Company has never been financed or expanded through borrowed money. We have never borrowed money except on short term borrowings. The Company has never sold any stock or bonds to the public. All the ex-

pansions of the business have been out of earnings. I am one of the stockholders.

When Mr. Kohl had one store he promised me he would have ten some day. After he had ten and he thought if I would stay a little longer maybe he would have a hundred, and that has always been his policy right along. Then as the money accumulated there was some competition that was troublesome and he expressed a desire to be able to buy them out some day.

I believe in 1919 we had two hundred stores. At that time Mr. Kohl was figuring on having a thousand. When he got up to six and eight hundred stores his plan was to have two thousand stores. Our present warehouse was built to take care of between 1500 and 2000 stores. The present warehouse was built in the late twenties, and is a six story building. The bakery would supply probably one thousand stores in its capacity when built, but we are in process of rebuilding that now in order to put in modern machinery to take care of the stores that we hope to open. When the present machinery is installed it will double our present output. As far as the size of the building goes, the ovens and machinery will supply fifteen hundred stores.

Mr. Kohl borrowed from the National Grocery Company $100,000 in the fiscal year 1930 to pay a note in the Commercial Trust Company for $100,000 that he took out at the time he paid his donation of $100,000 to complete the big building for the Young Women's Christian Association on the hill in Jersey City. To make that gift he borrowed $100,000 from the Commercial Trust Company, and paid his gift with the borrowed money, and he later borrowed from the Grocery Company

enough to pay that note. The reason he borrowed from the Company, instead of declaring a dividend was that he expected to pay that back, and it would not depreciate the surplus account, but had he declared a dividend that was then out of surplus and might have hurt our credit. It has always been his policy to keep in the business every possible dollar that he did not need for living expenses.

"Q. Was it ever his purpose as expressed to you, as far as you know, not to pay a dividend to avoid any taxes? A. It was not."

My duties are to assist the President, have charge of the office and office force, and assist the Vice President in the rountine operation of the business. Everything in connection with the operation of the business comes to my attention. All of the buying is reported to Mr. Kohl and I get it from his reports. I have direct supervision of the employees in the office, and indirect supervision in the warehouse.

It is my opinion, as Treasurer of the Company, that in the year 1930 the surplus was not in excess of the reasonable needs of the business, and is not today, although conditions are different. In order to finance the purchase of $20,000,000 worth of merchandise and pay a million dollars in rents per annum, the Company required its surplus, in my opinion. There were times even at that when we were short of cash, and had to borrow temporarily from the banks in order to pay for incoming merchandise.

We had discussed from time to time Mr. Kohl's negotiations for the purchase of other existing chains of stores. I heard about the conversations

with Mr. Bohack in 1930, but I did not attend the conferences. A little more than five or six years ago Mr. Kohl contemplated the purchase of another chain of stores, one chain being in Paterson. That matter came up several times. That might have been around 1929 or 1930. The other chain was earlier than that.

In 1930 there was under contemplation the expansion of the business by the opening of a chain of stores in New York after the opening of the George Washington Bridge. We figured it would be a little cheaper to deliver merchandise and quicker to deliver it since the George Washington Bridge was open than by ferry. In the course of our business we should have our stores within easy trucking distances of the central warehouse. Our purpose in expansion is to keep within trucking radius of our central warehouses. There were so many surveys made with the idea of our opening a chain of stores in New York City, that I would not be able to tell in what years they were made. That has been constantly in the minds of Mr. Kohl and myself for many years. Every time anybody came to New York and saw the business that was there, and we were so close to it, we hoped some day to get that business. Every time our store superintendents or real estate department made investigations we found the rents were prohibitive for our type of business. It is a matter of cost and expense. We have the ability to finance and have maintained our ability to finance expansion as, if and when the time is ripe, either by buying an existing chain or by buying new stores. That has been Mr. Kohl's purpose in keeping the surplus in his business.

In the year 1930 Mr. Kohl borrowed from the National Grocery Company $140,000. At that time

Mr. Kohl developed a heart condition. His health was failing and that year he purchased a home in Palm Beach, Florida, and borrowed the money from the corporation to pay for the house. All of that money has been repaid to the corporation.

Every time Mr. Kohl borrowed money from the National Grocery Company, the amount loaned him was entered on the books under the head of "notes receivable", and every borrowing is shown on every statement that the Company has made.

I produce a memorandum from myself to my assistant, Mr. Botti, dated March 16, 1931, reading as follows:

> "The National Grocery Company has today declared a dividend of $100,000 in favor of its present stockholders. $60,000 of this dividend is to be credited to Mr. Kohl in the bills receivable account in payment of $60,000 of his notes and $40,000 check to be drawn to the order of Mr. Kohl and deposited to his credit in his account in the Hudson County National Bank."

This was the order for the entries to be made on the books. The Directors' meeting that declared this dividend was held three or four days later.

In the year 1930 there was a general decline in the market value of all assets, including our inventory of merchandise, our inventory of groceries, and our inventory of securities. I am not positive as to the extent of the decline in our merchandise inventory, but as far as I recall, it was between $200,000 and $250,000. At the end of the year we had at least as much merchandise to serve the stores as we had at the beginning of the year, if we had as many stores, but I believe we had more

stores. As I recall we carried an inventory of merchandise of about two and one-half million dollars. Of this about $700,000 or $800,000 was in the stores, I think, and the balance was in the central warehouse, with the possible exception of what might have been in outside warehouses.

Although the number of stores has declined somewhat, the reason is due to just the general depression. We would like to expand the business just the same.

Referring to the discounts taken, we have always followed the practice of taking discounts.

We have followed the practice of self-insuring some of our lines. The insurance reserves shown on our statements are computed on whatever the rate would be to insure the item or commodity in a regular insurance company, and that is set aside as a reserve. Any losses against the account are charged to that reserve. If we should have a batch of bread go wrong and people should be injured and start suit against the Company, that would be against the reserve. Suits against the Company for alleged improper merchandise, or breach of warranty, are not insured in outside companies, but would be charged against the reserve. We have had such suits brought against the Company. We insure the merchandise in the central warehouses against loss by fire in outside companies; that is because the large risk is concentrated in one building. Public liability insurance on our trucks is also covered by an outside company.

The reserves for income taxes that are not presently carried, but are shown on our older balance sheets, were carried because there was an assessment undetermined, and the various adjustments from different years have been taken out of that reserve.

Statement of Evidence and Exhibits 1-24 Inclusive and "A".

Somewhat over one hundred thousand persons per day enter and leave the various stores of the National Grocery Company.

Mr. Kohl never put anything into the business in the way of securities or contributions to the capital from the time the business was incorporated to this date. In other words, there has been nothing put into the Company, except what was contributed in the way of he original three stores when the National Groce Company was formed in 1908, and the stores that were in the Henry Kohl Company when it was merged into the National Grocery Company in 1911. All the rest of the surplus has been built up out of the earnings of the business.

Cross-examination:

I really don't know when the George Washington Bridge was officially opened. I don't know when the construction began. I could not tell you when Mr. Kohl made his first survey of business in New York. Mr. Kohl has been thinking of going to New York for many years. He made one attempt that was unsuccessful. That was before the Bridge was thought of. The first survey was made, I believe, about the time when the Washington Bridge was an assured thing. I have no idea how many years ago that was.

A dividend of $100,000 was declared by the National Grocery Company shortly after and about two months after the close of the fiscal year in question. I don't suppose that one dividend hurt the credit. The next year the National Grocery Company declared another dividend of $100,000. I think as it went on (payment of dividends) it did hurt our credit. I think that both the divi-

dends and the condition of the market added to hurting our credit.

$800,000 in dividends between January 31, 1931, and January 23, 1936, is a considerable sum, and yet we are figuring on expansion. We were figuring on expansion at the time we declared the first $200,000 dividend.

Prior to 1929 and 1930 market values of our assets had been going up. Values were increasing. Previous to 1930 we declared no dividends, except the two $25,000 dividends. Neither the rise nor fall in values affected the declaration of dividends. The market value of assets did not have any influence on the declaration of dividends.

It was my error that interest was not collected from Mr. Kohl on his loans. I ignored the fact that some of his notes were interest bearing, and some were not. I will have to take the blame for that. He did not pay any interest on any of his loans. By the close of 1931, Mr. Kohl had borrowed $610,000 from the National Grocery Company over a period from 1921, on which he had not paid one single penny of interest. There is owing to the Company still by Mr. Kohl on his loans over $400,000. He is not paying interest now.

Re-direct examination:

In the year 1930, while the declines were going on in the list of securities, I kept an accurate watch and reported to Mr. Kohl how they were sliding in value. They were watched every four weeks right through that year. Prior to January 1, 1930, we only made an observation as to the market condition of securities at the termination of the years previous to the crash in the market, but during the year 1930, when the values slid so rapidly, we watched the prices every four weeks.

"Q. You have been asked, Miss Mullins, by counsel, about the declaration of dividends since 1930. Why did the policy change after that instead of not declaring them prior to that? A. Well, of course, we know how the government felt about surpluses and we were advised that although we needed the money for expansion, just as badly as we did previous to that time, it was deemed advisable to save ourselves trouble like this, and declare it anyway even if it hindered expansion."

Re-cross examination:

I studied the income tax law prior to 1931, and assisted in making out the returns both for the corporation and for Mr. Kohl, and knew of the existence of Section 104 of the Revenue Act of 1928, and Section 220 of the previous Revenue Acts.

The gross sales from year to year were practically for cash. The amount of sales that were not for cash would not amount to very much comparatively.

Re-direct examination:

I also knew, from my knowledge of the Revenue Law, that the Commissioner of Internal Revenue had decided that up as far as 1928 the National Grocery Company did not have an excessive capital or surplus.

William J. Field, a witness on behalf of the petition, being duly sworn testified that he resides in Jersey City, is President of Commercial Trust Company of New Jersey, and has been for twelve years, and has been in the banking business for forty-six years, and is a former President of the New Jersey Bankers Association.

He has known Mr. Kohl since about 1900 or 1901, and the National Grocery Company since it was incorporated.

I have made an examination of Exhibit P-6, the built-up balance sheet of the National Grocery Company, and also the statements of the increase of the corporation's surplus, amount of taxes it has paid to the Government, net profits, and amount of salary paid to Mr. Kohl, and I have made a study of these exhibits. I am familiar with the fact that in the year 1930 Mr. Kohl paid himself a salary as President of the Company of $104,000, and that the Federal taxes the Company paid that year were $103,616, and that the net addition to the capital and surplus, as shown by the tax return for the year, was $682,850, and that the securities owned by the National Grocery Company depreciated in value during that year in excess of $900,000.

When asked whether in his opinion the capital and surplus of the National Grocery Company for the calendar year ending January 31, 1931, was in excess of the reasonable needs of the business, Mr. Field testified:

> "I don't think it was in excess of reasonable requirements and reasonable safety of the business. The working capital at the end of 1930 was $3,700,000 odd. The working capital at the end of January, 1931, was $4,500,000. We were starting on a panic or panicky conditions. No one could foretell the future at that time. The National Grocery Company had a turnover of from six to eight times its capital in the volume of business it did in those years. It is true that some of the other chain stores in the grocery lines had a turn-

over of from 10 to 12 per cent, but the National Grocery Company showed a much safer condition by turning over at a smaller percentage than the other companies. They had experience in previous years of rather large losses on inventory, and naturally they should keep a considerable working capital and a surplus to meet any additional losses they might encounter. . . . This company had accumulated a surplus, a good part of which was invested in stocks and bonds. After the depression, in 1929, these securities went off very considerably in market value. Many of them were what was known as over-the-counter securities. There was a large proportion of bank stocks and it was found they went off in market value, bank stocks outside of New York City could not be sold even at the so-called market value in those times—the conditions that prevailed with bank stocks or stocks of banks located outside of New York City.

This company has been built up since 1908 by an accumulation of profits and has been expanded through that accumulation until 1932. But by adding the profits to the surplus they have gone from three stores to eight hundred odd stores. A company like the National Grocery Company cannot expand unless it covers the total territory that can be covered by a motor truck from its central unit, and to get the full advanage of a chain store business they must cover that territory. As soon as the 1930 depression came, the National Grocery Company having a few over eight hundred stores stopped its expan-

sion and traveled along with about that number of stores.

The idea of putting the surplus—of retaining the surplus in 1930, was no different from any year up to that time. The surplus has always been accumulated for expansion purposes, not only to build up the business but to insure the most economical management of the business, because it could not be carried on successfully unless they had this expansion in number of stores. The stores are a distributing unit of distribution for the central unit.

The accumulation of these earnings in the past years has enabled the National Grocery Company to buy advantageously and always to have a proper working capital, although in several years leading up to 1930 they found it necessary to borrow money in addition to the money that was available. Their accumulation of the surplus, invested in securities, enabled them to show a proper credit statement and hence their ability to borrow whenever they wanted, at low rates of interest."

When asked whether in his opinion for the year 1930, where the Company had a depreciation in value of its securities, and a large portion of these securities were over-the-counter securities, such as bank stocks and insurance stocks, it was good or poor business judgment not to declare dividends, he said:

"I think it was a very wise policy to conserve all of their assets at that time."

When asked how he would construe the fact that Mr. Kohl that year borrowed $140,000 on demand notes from his own Company, he testified:

"I don't think it would have made much difference whether he borrowed the money from the bank or his own company."

I have had a lot of experience with the National Grocery Company over the past years. My bank has had their account for many years. We have loaned them money year after year. We have had reports of the condition of the National Grocery Company year by year, and the fact that the policy of the Company has been to keep its working capital in the business, rather than distribute it, and invest that capital in securities, has enhanced its credit standing very materially to have these securities back of the merchandise inventory.

Mr. Kohl has talked to me once or twice about wanting to purchase other chains of stores, if the opportunity offered. On his behalf, I approached one chain of stores two or three times to see if it was in the market for sale so that Mr. Kohl might buy it, but they showed no evidence of wanting to sell. This was several years ago. I do not recall how long ago.

I remember that after the War, I should say it was in 1920 or 1921 or 1922, when most corporations were writing down inventory, the National Grocery Company had a very large loss due to the decline in the price of sugar. It was essential for the National Grocery Company in those times to have sugar and coffee and so on, sufficient to supply the stores. The only way they could be sure of a sufficient supply was to go to the open market and buy at the prevailing prices, and they had quite a large inventory in sugar. After the War was over these inventories all went down. Almost every corporation was affected the same way. There were tremendous losses in all corporations

through writing down inventories. This Company stood that loss because it had ample funds.

Cross-examination:

I believe that the National Grocery Company has an account with the Trust Company of New Jersey, but I have always understood they have their principal account with the Commercial Trust Company, of which I am President. It is not to my interest today to have as much cash in my bank at all times as possible, but it was up to 1931. The credit of the National Grocery Company has not been impaired at any time from the beginning to the present time. It is as good today as it was ten years ago.

I have a memorandum submitted to me of the number of dividends declared since January 31, 1931. I should not think the payment of those dividends would impair the credit of the National Grocery Company. It has not in my opinion. If the National Grocery Company had declared a dividend of $100,000 in the year ending January 31, 1931, I do not think it would have impaired the credit of the Company at my bank. Had they declared dividends of $100,000 each year from 1925, I do not think it would have impaired their credit at my bank.

The increase in stores from 799 in 1930 to 815 stores in 1931, would have required some increase in capital requirements. I do not think the difference between 815 and 819 stores would be very material as affecting the capital requirements. Between 1930 and 1931 there was an increase of 16 stores. Over the next two years only an increase of four stores. This increase would require very slightly more capital. I think they could have

declared a dividend at the same time, because evidently their policy at that time was not to expand in stores. Although there were 16 more stores in 1931 than in 1930, there was no reason why the Company could not have declared a dividend in 1930 from the standpoint of need of capital, except that because of conditions that prevailed at the time any conservative management would have conserved all of its ready cash, because they did not know what the future would bring forth.

I think the Company could have declared a dividend in 1930, as well as 1931, but with conditions as they were pointing at the time it was much wiser to conserve the moneys than to pay them out in dividends. They could have declared a dividend. That condition began in 1929.

In 1927 the Company had 625 stores; in 1928 715 stores. The reason they did not declare a dividend in those years was because of the need of the extra capital and their policy of continuing an expansion of the stores. They did not know in 1927 that they were going to stop expanding their stores. In 1929 there was the panic and that is when they began to think over the situation. The panic began in October, 1929. I think the Company entirely lost confidence in January, 1931, on account of what had happened in October, 1929. The figures show that they only had four additional stores in 1932, and the number has been falling since then, and the figures show that their policy of expanding stopped. I am judging that mostly from the figures. I have no personal knowledge, excepting the figures. I have read the figures to pass on credits. Eliminating the figures, I have no knowledge of the policy of the Company.

I am aware of the amount of loans from the corporation to Mr. Kohl from 1922 to 1931, merely

from the figures shown on the statements of the Company. I presume that Mr. Kohl's borrowings from the corporation was a good asset for the corporation.

Re-direct examination:

We have considered the item of $610,000 owed by Mr. Kohl to National Grocery Company an asset of the Company, collectible whenever the Company elected to collect it.

Re-cross-examination:

I base my answer on Mr. Kohl's general standing and responsibility. I have no statement before me of his assets, but I know he owns real estate at Rumson, Monmouth County, New Jersey, where he has quite an estate. That is just one item I know. We have always considered in the bank that Mr. Kohl was good for any of his obligations.

Frank C. Ferguson, a witness on behalf of the petitioner, being duly sworn, testified that he resides in East Orange, New Jersey; is President of the Hudson County National Bank, and Chairman of the Port of New York Authority of the Port of New York; has been President of the Hudson County National Bank for twenty years, and Chairman of the Port Authority for twelve years.

I have examined the statements of the National Grocery Company as to the number of stores operated, sales, balance sheets, statement of profits, and other exhibits in the case.

In my opinion for the year ending January 31, 1931, the surplus of the corporation was not in excess of the reasonable needs of the business. In

my opinion it was good sound business practice for the Company in that year not to declare any dividends, because in view of the times it was important to conserve all cash resources.

I am familiar with the inventory of securities owned by the National Grocery Company in the year ending January 31, 1931. For the purposes of the business you would have to eliminate entirely from the statement of the National Grocery Company all the shares of stock in Jersey City and Hoboken banks, because they had no liquidity. When asked what effect the depression had on the salability of local bank stocks, Mr. Ferguson testified:

> "For a time we tried to peg the market and found it impossible. Had to let the market go. I could not sell the bank stocks of these banks with the possible exception of the Commercial Trust Company, which always maintained somewhat of a market. But the rest of the stocks, including my own bank's stocks, were absolutely unsalable at any time in this period. . . .
>
> As I have already stated, those securities could not have been sold nor could they have been used as collateral securities for a loan. As a matter of fact, they could not be used as collateral securities for a loan today in any bank that I know of."

Cross-examination:

None of the local bank stocks could have been sold on January 31, 1931. The market for bank stocks entirely disappeared in the latter part of October and November and December, 1930. They could not have been sold. They had no market

value at that time. Stocks listed in these schedules, in the quantities listed in these schedules had no market value on January 31, 1931. By that I do not mean to say that a few shares of each of these bank stocks could not have been sold in the market at that time, but you are asking me about the quantities of stocks contained in this portfolio. I cannot think of any bank stocks in Jersey that had any market value on January 31, 1931. The stock in my own bank that was owned by the National Grocery Company at that time had no market value. I am talking about this portfolio. I am just as frank about the stock in my own bank as I am about the stock in any other. We tried for a while to peg the market and we got licked. I don't know how long it was. We made the discovery very shortly after we tried to peg it. That was very shortly after the big break in the market.

The National Grocery Company could have declared a dividend in 1930, and it would not have impaired the business of the National Grocery Company. As far as I know it might have declared a dividend in 1929. I am reasonably familiar with the business of the National Grocery Company, but not anywhere near as familiar with it as Mr. Field. I am well acquainted with Mr. Kohl and know his financial reputation and standing. The Company might have declared a dividend in 1928, and not impaired the business.

Fred J. Armbruster, a witness on behalf of the petitioner, being duly sworn, testified that he resides in Montclair, New Jersey. His business is stocks and bonds and he is with the firm of Outwater & Wells, Jersey City, specializing in municipal bonds, public utilities, bank stocks, and insurance stocks.

Statement of Evidence and Exhibits 1-24 Inclusive and "A".

I appraised at counsel's request the bank and insurance company stocks owned by the National Grocery Company as of January 31, 1930, and January 31, 1931. I secured the information as to the price per share or value per share from various sources. Where we were able to arrive at a price according to our own books, actual transactions having transpired, we used that. We also referred to the Financial Chronicle where our records showed nothing. We also referred to our own quotation sheet that came out at that time which would give us a line as to what was in the market; that gave a pretty good idea of how things were offered and what bids were being made.

The figures on Commercial Trust Company were taken entirely from our own records of actual transactions that we had; also First National Bank of Jersey City, and Hudson County National Bank. The First National Bank of Hoboken was the result of the Chronicle and our own quotation sheet, we having had no actual transactions in that.

The last sale prior to January 31, 1931, on the First National Bank of Jersey City was on the 22nd day of December, 1930, for $50. The First National of Hoboken showed absolutely nothing beyond the early part of 1929, and I don't know what those figures were. I have not them here. We stopped trading in First National of Hoboken after the early part of 1929, and showed no more transactions. That Bank merged with the First National Bank of Jersey City about a year ago, with serious loss to the stockholders.

The fair market value of the stock of the Hudson County National Bank as of January 31, 1931,

was $83 a share; First National Bank of Jersey City $50 a share; Commercial Trust Company $132 a share; New Jersey Title Guarantee & Trust Company $95 a share.

In my opinion it would not have been possible in January, 1931, to have liquidated the National Grocery Company's inventory of bank stocks. We were having difficulty in trying to trade in lots of 15 and 20 and maybe 25 shares, and occasionally a 50 share lot. Our records show that the trades, what few there were, were in small lots. These prices are the prices of small lots of bank stocks of those particular banks. You could have traded in those bank stocks about 1933 or 1934, in a little bit larger quantities, and it all depended upon conditions. There may be a rumor prevalent that something might transpire in a certain bank which might arouse a flurry for a short period of time.

Cross-examination:

The local bank stocks could not have been liquidated on January 31, 1931. Even in our best bank stocks, big blocks like that, if put on the market, would have raised havoc. I am basing my answer on the basis of the blocks represented in this portfolio. I am giving my testimony on the lack of marketability if they were all placed on the market at one time. The bank stocks could not have been liquidated in January, 1930, because we had declared a condition which started around the middle of December, 1929, and ended about April of 1930, where you could not trade in any of the stocks of the five large Jersey City banks. After April, 1930, you might have done it in small lots. My figures show 15 and 20 and 30

shares. The period in between was due to an embargo on bank stocks. There was an agreement made between the banks, on bank stocks, and the brokers to maintain values in order not to impair collateral loans. Everybody knew about it. Everybody knew they could not trade in local bank stocks at that time. There was no market. I do not know whether the New York Times and the Chronicle and the like had knowledge of this agreement. I do not know whether or not it would have been to our advantage to have published the agreement. This was not an act of the brokers. We were requested by the banks to do that and we did it. We were acting in cooperation with the Banks, in order not to impair collateral loans, but they did not realize what would happen. We did not impair collateral loans for that period of time, so far as trading in those five Jersey City bank stocks were concerned. That only applies to five banks.

The inventory might have been liquidated piecemeal on January 31, 1929. You could not sell blocks like that if thrown on the market at any time. There was trading in the stocks in January, 1929. I do not know whether the stocks in this portfolio were in such large quantities that the market might not have gradually absorbed them. An awful lot of stock is represented and if that was the only stock on the market, I would say it could have been gradually absorbed because there was a lot of speculation at that time.

On January 31, 1929, there might have been considerable difficulty in liquidating the 5850 shares of stock of the Commercial Trust Company because of the amount of stock involved with a value of one million and eighty-two odd thousand dollars. That amount could not have been

liquidated over a period of three or four months. I get the values on the Commercial Trust Company stock from our own trades that we made during that time—actual sales.

Percy A. Gaddis, a witness on behalf of the petitioner, being duly sworn, testified that he resides at Red Bank, New Jersey, and is an appraiser and consultant in real estate matters at 900 Bergen Avenue, Jersey City. He has been in the real estate business in Jersey City continuously since 1893, and qualified as an expert in real estate values.

He testified that he had made an examination of the real estate holdings of the National Grocery Company in Jersey City, including the office and warehouse buildings, the old warehouse, bakery and garages, and had made a map and an inventory and appraisal.

He testified that in his opinion the fair market value of the buildings, machinery and equipment, shown on the balance sheet as permanent assets, had declined in value during the year ending January 31, 1931, because of the general market conditions, by $125,000.

The foregoing Statement of Evidence sets forth all of the material evidence adduced at the hearing of this cause bearing upon the issues raised in the Petition for Review, and, in order that the same may be preserved and made a part of this record, said Statement of Evidence is duly approved, settled, and ordered filed this 23rd day of January, 1937.

CHARLES P. SMITH
Member, United States Board of Tax Appeals.

Statement of Evidence and Exhibits 1-24 Inclusive and "A".

Agreement as to Record.

IT IS HEREBY STIPULATED by the attorneys for the petitioner and the respondent, as follows:

(1) The foregoing statement is agreed upon as a correct statement of the opening of the case before the Board Member, and a correct narrative statement of the testimony before the Board.

(2) The only portion of Exhibit 3 for petitioner, being the Certificate of Incorporation of National Grocery Company, that need be printed is that annexed hereto.

(3) Copies of the income tax returns filed by Henry Kohl for the years 1922 to 1930, inclusive, marked Exhibits C to K, inclusive, and the tax return of the National Grocery Company for the fiscal year ended January 31, 1931, marked respondent's Exhibit B, need not be printed in the record. Three photostatic copies of each return shall be sent to the Clerk of the United States Circuit Court of Appeals for the use of the Judges, and shall be submitted with the record for the consideration of the Court.

(4) The foregoing narrative statement, together with the annexed copy of Exhibit 3, and all other exhibits in the cause, shall constitute the Statement of Evidence on the appeal in the within matter, and be printed as the record, except as noted in paragraph 3 hereof.

Dated: January 8th, 1937.

JAMES D. CARPENTER, JR.,
Attorney for Petitioner.

MORRISON SHAFROTH,
Attorney for Respondent.

Exhibit 1.

Exhibit A.

Office of
Commissioner of Internal Revenue
Treasury Department
Washington

IT:CA:2112-3-60D Apr. 11, 1927.
National Grocery Company,
480 Montgomery Street,
Jersey City, New Jersey.

Sirs:

The determination of your income tax liability for the years ended January 31, 1923 and January 31, 1924, pursuant to an examination of your books of account and records, disclosed a deficiency in tax amounting to $349,993.54, as shown in the attached statement.

In accordance with the provisions of Section 274 of the Revenue Act of 1926, you are allowed 60 days from the date of mailing of this letter within which to file a petition for the redetermination of this deficiency. Any such petition must be addressed to the United States Board of Tax Appeals, Earle Building, Washington, D. C., and must be mailed in time to reach the Board within the 60-day period, not counting Sunday as the sixtieth day.

Where a taxpayer has been given an opportunity to file a petition with the United States Board of Tax Appeals and has not done so within the 60 days prescribed and an assessment has been made, or where a taxpayer has filed a petition and an assessment in accordance with the final deci-

sion on such petition has been made, the unpaid amount of the assessment must be paid upon notice and demand from the Collector of Internal Revenue. No claim for abatement can be entertained.

If you acquiesce in this determination and do not desire to file a petition with the United States Board of Tax Appeals, you are requested to execute a waiver of your right to file a petition with the United States Board of Tax Appeals on the inclosed Form A, and forward it to the Commissioner of Internal Revenue, Washington, D. C., for the attention of IT:CA:2112-3-60D. In the event that you acquiesce in a part of the determination, the waiver should be executed with respect to the items to which you agree.

Respectfully,

D. H. BLAIR,
Commissioner.

By C. R. NASH,
Assistant to the Commissioner.

Inclosures:
Statement
Form A
Form 882

Exhibit 1.

STATEMENT

IT:CA:2112-3-60D

In re: National Grocery Company,
480 Montgomery Street,
Jersey City, New Jersey.

Fiscal Years Ended	Deficiency in Tax
January 31, 1923	$165,322.60
January 31, 1924	184,670.94
Total	$349,993.54

January 31, 1923

Net income reported		$549,340.20
Additions:		
1. Excessive depreciation	$ 9,146.50	
2. Furniture and fixtures	20,319.39	
3. Insurance reserve income	45,167.58	
Total additions		74,633.47
Net income as adjusted		$623,973.67

Explanation of Adjustments to Net Income

1. Depreciation allowed under provisions of Article 161, Regulations 62.

Amount of depreciation allowed	$48,214.39
Amount of depreciation taken	57,360.89
Amount disallowed	$ 9,146.50

2. Furniture and fixtures, included in expense account which should be capitalized, Article 581, Regulations 62.

3. Self-insurance charges, not covered by damages or reflected in net credit for year to insurance reserve indicate profit not reported.

Exhibit 1.

STATEMENT

National Grocery Company
Computation of Tax

Net income	$623,973.67
Amount of tax under Section 220—25%	$155,993.42
Amount of tax at 12½%	77,996.71
Total	$233,990.13
Original tax	68,667.53
Additional tax	$165,322.60

January 31, 1924

Net income reported		$556,704.21
Additions:		
1. Excessive depreciation	$ 4,633.11	
2. Furniture and fixtures	16,005.99	
3. Insurance reserve increase	60,268.19	
Total additions		80,907.29
Net income as adjusted		$637,611.50

Explanation of Adjustments to Net Income

1. Same as #1 for 1923.

Depreciation allowed	$58,728.50
Depreciation claimed	63,361.61
Depreciation disallowed	$ 4,633.11

2. See #2 explanation to net income 1923.

3. See #3 explanation to net income 1923.

Exhibit 1.

Computation of Tax

Net Income		$637,611.50
Tax under Section 220—1921 law—@ 25% —$159,402.88 for 11 months		$146,119.31

STATEMENT

National Grocery Company

	Forward	$146,119.31
Tax under Section 220—1924 law @ 50%		
Taxable income	$637,611.50	
Add:		
United States Obligations	26,210.89	
Dividends	18,694.80	
Total income	$682,517.19	
	341,258.60 for 1 month	28,438.22
Total tax under Section 220		$174,557.53
Amount of tax at 12½%		79,701.44
Total		$254,258.97
Original tax		69,588.03
Deficiency in tax		$184,670.94

Payment of the tax should not be made until a bill is received from the Collector of Internal Revenue for your district, and remittance should then be made to him.

Due to the fact that the statute of limitation will presently bar any assessment of additional tax against you for the fiscal year ended January 31, 1923, the Bureau will be unable to afford you an opportunity to discuss

Exhibit 1.

your case before mailing formal notice of its determination as provided by Section 279(a) of the Revenue Act of 1926. It is necessary at this time, in order to protect the interests of the Government, to issue a formal notice of deficiency.

Exhibit B.

TREASURY DEPARTMENT
Washington

Office of
Commissioner of Internal Revenue

Address reply to
Commissioner of Internal Revenue
and Refer to
IT:E:RR
GES

May 2, 1928

National Grocery Company,
480 Montgomery Street,
Jersey City, New Jersey.

Sirs:

Reference is made to your protest against the decision contained in office letters of April 14, 1927 and May 31, 1927 with respect to the tax liability of your Company for the fiscal years ended January 31, 1923 and January 31, 1924 under the provisions of Section 220 of the Revenue Acts of 1921 and 1924.

You are advised that after careful consideration of all the facts and figures set forth in your

protest, at hearings held with your representative, Mr. J. M. Enright, and data subsequently submitted, it has been determined that the evidence in the case does not show an unreasonable accumulation of gains and profits for either of the two years mentioned.

In view thereof your protest has been sustained and it is held that your Company is not subject to taxation under the provisions of Section 220 of the Revenue Acts of 1921 and 1924 for the fiscal years ended January 31, 1923 and January 31, 1924.

A copy of the General Counsel's recommendation in the case which has been approved by this office is enclosed for your information.

Respectfully,

D. H. BLAIR
Commissioner

Enclosure:
Copy of Recommendation.

GC:1:1
A-222130

In re: National Grocery Company,
Jersey City, N. J.

April 14, 1928

MR. COMMISSIONER:

This office has given careful consideration to the protest of the National Grocery Company, 480 Montgomery Street, Jersey City, New Jersey,

against the application of the provisions of Section 220 of the Revenue Acts of 1921 and 1924 for the fiscal years ended January 31, 1923, and January 31, 1924.

Hearings in the case were held in this office on July 19 and October 29, 1927, at which the taxpayer was represented by Mr. J. M. Enright, 75 Montgomery Street, Jersey City, New Jersey. From the evidence previously on file, adduced at the hearings and submitted subsequent thereto the following facts appear:

The taxpayer is engaged in the business of operating a chain store system of retail grocery stores employing the "cash and carry" plan. The corporation was organized under the laws of the State of New Jersey in 1908, with an authorized capitalization of $5,000.00, which was increased in 1911 to $200,000.00. All of its capital stock, except qualifying shares, was held by Mr. Henry Kohl, President of the Company, during the period under review. From a business consisting in 1908 of three retail grocery stores with gross sales of $181,028.79, the taxpayer has increased its operations so that at the end of January, 1927, it was operating 625 stores with gross sales of $19,239,740.66. The net profits (as adjusted) for 1923 were $589,278.25 and for 1924, $620,496.86, no part of which was distributed as dividends but all added to surplus, which at the close of the fiscal year ended January 31, 1924, amounted to $3,550,979.07.

A schedule submitted by the taxpayer of the stores operated, the gross sales, and the net profits for the period 1908 to 1927, is as follows:

Exhibit 1.

Year	Number of Stores Operated	Increase over Preceding Year	Gross Sales	Net Profits Per Books	Net Profits as Adjusted
1908	3		$ 181,028.79	$ 4,584.39	$ 4,584.39
1909	11	8	267,414.46	7,144.23	7,144.23
1910	24	13	601,350.44	40,806.96	40,806.96
1911	38	14	975,532.76	58,601.38	58,601.38
1912	55	17	1,387,924.15	74,931.22	74,931.22
1913	81	26	1,899,323.66	66,989.90	66,989.90
1914	104	23	2,603,213.96	101,954.66	101,954.66
1915	132	28	3,446,218.84	173,180.81	182,842.58
1916	169	37	3,924,470.57	124,451.65	153,728.16
1917	217	48	5,494,394.70	235,885.21	296,567.73
1918	268	51	8,749,196.50	584,841.59	677,735.20
1919	290	22	10,623,466.32	274,249.13	525,227.94
1920	311	21	12,602,935.14	323,934.24	584,533.65
1921	344	33	15,036,341.52	119,156.70	341,238.70
1922	359	15	13,542,171.36	357,445.30	422,045.98
1923	389	30	13,721,399.46	498,800.46	549,340.20
1924	449	60	15,378,387.45	582,407.28	556,704.21
1925	483	34	15,973,716.30	581,745.32	543,485.49
1926	537	54	17,321,525.50	576,592.13	517,791.38
1927	625	88	19,239,740.66	565,507.90	493,387.26

During the year 1911 the profits were at the rate of $1,362 for each store, and during 1926 the average profits for each store were $789.00. Since 1915 the business of the Company has been developed in line with the policy of ultimately operating a chain system of 1,000 stores, and the financial management, plant development and general policies have been based upon such ultimate operation, although a more recent policy has contemplated a chain system of 2,000 stores.

The comparative balance sheets for the period February 1, 1922 to January 31, 1924, reflect the following items:

Exhibit 1.

Assets	February 1, 1922	January 31, 1923	January 31, 1924
Cash	$ 556,262.39	$ 360,939.09	$ 506,629.97
Accounts Receivable	90,663.17	14,524.71	5,898.73
Notes Receivable	100,000.00	0	24,465.28
Sundry Claims, Loans and other Receivables	28,169.81	59,448.47	100,593.27
Inventories	1,372,140.87	2,184,282.30	1,890,315.11
Deferred Charges	11,819.80	9,679.94	20,718.55
Investments:			
U. S. and Mun. Bonds	490,000.00	510,294.57	751,469.58
Capital Stocks of Com. Corporations	128,210.00	264,421.25	347,331.25
Bonds (Other Corp.)	2,500.00	37,729.16	263,272.74
Capital Assets:			
Land	30,500.00	30,500.00	69,348.50
Buildings	408,665.86	408,665.86	413,427.66
Utensils	18,373.58	11,092.17	4,406.85
Machinery	38,474.08	38,474.08	41,504.05
Fixtures and Rolling Stocks	97,857.81	114,867.81	205,884.93
Capital Expenditures Restored in Audit of Prior Years	49,075.14	69,394.53	85,400.52
	$3,422,712.51	$4,114,313.94	$4,730,666.99
Liabilities and Capital			
Notes Payable	$ 20,250.00	$ 14,750.00	$ 14,750.00
Accounts Payable	167,235.81	240,806.42	180,811.26
Accrued Liabilities	8,588.27	5,849.06	9,657.23
Reserve for Depreciation	207,070.75	244,062.43	296,105.81
Capital Stock	200,000.00	200,000.00	200,000.00
Surplus	2,521,957.52	2,991,670.90	3,550,979.07
Surplus Reserves:			
Res. for Fed. Tax	79,270.14	68,667.53	69,588.03
Res. for Contingencies	140,000.00	225,000.00	225,000.00
Res. for Insurance	78,340.02	123,567.60	183,775.79
	$3,422,712.51	$4,114,313.94	$4,730,666.99

The distribution of profits for 1923 and 1924 is shown by the following schedule:

Year	1923	1924
Reinvested in the Business	$397,543.37	$ 70,868.27
Invested in securities considered by the Unit as not needed in the business	191,734.88	549,628.59

Exhibit 1.

The taxpayer contends that its earnings for the fiscal years 1923 and 1924 were not distributed for the reason that the funds were needed for use in its business and were retained in accordance with a definite financial plan involving the application of its surplus to the following commitments:

1. The building program.
2. Increase in number of stores operated.
3. Additional Internal Revenue Tax proposed.
4. Insurance Reserve.
5. Necessity of maintaining large deposits in local banks.
6. Having a portion of its surplus invested in liquid securities so as to facilitate borrowing.

1. *Building Program.*

In 1916 negotiations were begun for acquiring property upon which to erect a warehouse and office building. In 1917 property was purchased which was later found to be unsuited for the purpose. Other property was sought and on June 15, 1923 such property was acquired, whereupon an architect was commissioned to prepare plans for erecting a ten-story building. The plans for this building, including equipment, called for an expenditure of approximately two million dollars. Later it was found necessary to curtail this project and a six-story building was erected on the property at an expenditure of $1,188,586.11. In 1921 plans had been prepared for the erection during 1923 and 1924 of an additional story on one of the Company's warehouse buildings at an estimated cost of $200,000.00. It was found expedient later to abandon this undertaking entirely.

Exhibit 1.

2. *Increase in Stores.*

Prior to the beginning of the fiscal year ended in 1923 the taxpayer was committed to a project involving a large increase in the number of stores operated, at an estimated outlay of capital for each store in the amount of $5,000. Thirty stores were added during 1923, sixty in 1924, thirty-four in 1925, fifty-four in 1926, and eighty-eight in 1927.

3. *Additional Tax in 1924.*

The taxpayer was notified in 1923 that it appeared to be subject to additional income tax for the years 1915 to 1920, approximating $400,000.00. At the end of 1926 there was actually paid for the period 1915 to 1922 additional tax in the amount of $131,066.55.

4. *Insurance Reserve.*

The taxpayer considered that inasmuch as its risks were scattered among so many units, it might profitably refrain from insuring with outside underwriters and set up its own reserve for carrying its risks. It began the building up of its own insurance reserve from contributions determined upon the basis of standard premium rates. The additions to this reserve fund during 1923 and 1924 amounted to $45,167.58 and $60,268.19 respectively.

5. *Bank Deposits.*

By reason of the wide area covered by the taxpayer's stores, it is necessary to make frequent cash collections from the various stores and deposit them in the nearest local banks from which local banks the funds are withdrawn by check to

a bank of central deposit. This local banking service is an accommodation to the Company and without profit to the local bank unless a substantial average deposit is carried. For this reason the deposit carried by the Company in local banks, although large in the aggregate, is not available for use. The Company from time to time is likely to have immediate use for large sums of money in excess of its bank balances and at such times is temporarily accommodated by overdrafts or short-term bank loans until collections have made up the deficit. Under the terms of this banking accommodation it is necessary that the Company maintain at all times large cash balances.

6. *Surplus Invested in Securities.*

By reason of a large surplus which the taxpayer has invested in substantial securities, it is able at all times to borrow large sums of money and it has been found to be more profitable to borrow from banks on the strength of this surplus than to sell its securities and repurchase them later. The needs of the business have involved considerable borrowing of funds and during the year 1924 outstanding loans reached $400,000.00, during 1925, $300,000.00, and in 1926 the peak was at $800,000.00.

It is the general contention of the taxpayer that its surplus was built up with the definite object of the expansion of its business and the increase of its physical plant assets. The present capital and surplus are still deemed inadequate for the operation of 1,000 stores, which was the minimum of the program originally adopted.

A careful study of the evidence on file leads to the conclusion that the earnings of the taxpayer were being accumulated solely for use in its business and in accordance with the reasonable needs

of that business as determined by a definite financial program adopted early in its history. Accordingly it would appear that the corporation was not availed of during the period under review for the purpose of preventing the imposition of the surtax upon its stockholders through the medium of permitting its gains and profits to accumulate beyond the reasonable needs of its business.

For the reasons above this office is of the opinion that the taxpayer has not incurred liability under section 220 of the Revenue Acts of 1921 and 1924 for the fiscal years ended in 1923 and 1924 and its protest to that effect should be sustained.

The administrative file of the Income Tax Unit is forwarded herewith.

(Signed) C. M. CHAREST,
General Counsel,
Bureau of Internal Revenue.

Approved:

(Signed) D. H. BLAIR,
Commissioner of Internal Revenue.

Encl.: Adm. File.
Ft.-4.

Exhibit 1.

Exhibit C.

STATEMENT.

TREASURY DEPARTMENT
BUREAU OF INTERNAL REVENUE
Washington

Office of
The General Counsel

Address Reply to The General Counsel
Bureau of Internal Revenue
and Refer to
GC:A

May 28, 1929.

John M. Enright, Esq.,
75 Montgomery Street,
Jersey City, New Jersey.

In re: Appeal of National Grocery Company,
Docket #29022.

Sir:

There are enclosed three copies of a proposed stipulation in connection with the above-entitled appeal now pending before the United States Board of Tax Appeals, giving effect to the elimination of the application of Section 220.

If you are in agreement with the proposed stipulation you are requested to sign the original and one carbon and return same to this office in order that the stipulation may then be filed with the Board and the appeal thus disposed of.

Exhibit 1.

For your convenience there is enclosed a copy of the computation of the proposed tax liability as revised.

Respectfully,

C. M. CHAREST,
General Counsel.

Enclosures:
3 copies of stipulation.
copy of computation of tax liability.

UNITED STATES BOARD OF TAX APPEALS.

NATIONAL GROCERY COMPANY, Petitioner, *vs.* COMMISSIONER OF INTERNAL REVENUE, Respondent.	DOCKET No. 21022.

STIPULATION.

It is hereby stipulated and agreed by and between the parties hereto by their respective counsel, that in the above-entitled appeal there are deficiencies in tax for the fiscal years ended January 31, 1923 and January 31, 1924 in the respective amounts of $9,329.18 and $10,113.41, and that the Board may enter an order of redetermination accordingly.

Exhibit 1.

It is understood and agreed that the Commissioner may assess and collect the said deficiencies immediately upon the issuance by the Board of its order of redetermination without regard to the restrictions, if any, contained in Section 274(a) of the Revenue Act of 1926 or Section 272(a) of the Revenue Act of 1928.

JOHN M. ENRIGHT,
McDERMOTT, ENRIGHT & CARPENTER,
Attorney for Petitioner.

.....
Attorney for Respondent.

HDT/fac.

STATEMENT.

SA:BJS
JEM:JJP

In re: National Grocery Company,
Jersey City, New Jersey.

Docket: #29022

Fiscal Year Ended:	Deficiency in Tax
January 31, 1923	$ 9,329.18
January 31, 1924	10,113.41
Total	$19,442.59

5

Exhibit 1.

NATIONAL GROCERY COMPANY

FISCAL YEAR ENDED JANUARY 31, 1923

Schedule 1

Net income as disclosed by Bureau letter dated April 11, 1927	$623,973.67
As corrected	623,973.67
Net adjustment	None

Schedule 2

Computation of Tax (Section 230)

Net Income—Schedule 1	$623,973.67	
Less:		
Exemption	None	
Taxable at 12½%	$623,973.67	
Tax at 12½%		$ 77,996.71
Tax assessed		68,667.53
Deficiency in tax		$ 9,329.18

Exhibit 1.

FISCAL YEAR ENDED JANUARY 31, 1924

Schedule 3

Net Income

Net income as disclosed by Bureau letter dated April 11, 1927		$637,611.50
As corrected		637,611.50
Net adjustment		None

Schedule 4

Computation of Tax (Section 230)

Net income—Schedule 3	$637,611.50	
Less:		
Exemption	None	
Taxable at 12½%	$637,611.50	
Tax at 12½%		$ 79,701.44
Tax assessed		69,588.03
Deficiency in tax		$ 10,113.41

Exhibit 1.

Exhibit D.

UNITED STATES BOARD OF TAX APPEALS,

WASHINGTON.

NATIONAL GROCERY COMPANY, Petitioner, *vs.* COMMISSIONER OF INTERNAL REVENUE, Respondent.	DOCKET No. 29022

DECISION

Under written stipulation signed by counsel for the parties in the above-entitled proceeding and filed with the Board on June 4, 1929, it is

ORDERED and DECIDED: That there are deficiencies for the fiscal years ended January 31, 1923 and January 31, 1924 in the amounts of $9,329.18 and $10,113.41, respectively.

(Signed BENJAMIN H. LITTLETON
Member,
United States Board of Tax Appeals

ENTERED
JUN 12 1929

Exhibit 2.

Exhibit E.

TREASURY DEPARTMENT
Washington

Office of
Commissioner of Internal
Revenue

Address Reply to
Commissioner of Internal Revenue
and Refer to
IT:E:RR
GES

February 1, 1930.

National Grocery Company,
300 Mercer Street,
Jersey City, New Jersey.

Sirs:

From an examination of the Federal income tax return filed by your corporation for the fiscal year ended January 31, 1928, it would appear that your corporation may have incurred liability under Section 220 of the Revenue Act of 1926 and Section 104 of the Revenue Act of 1928.

The provisions of Section 220 of the Revenue Act of 1926 are as follows:

"(a) If any corporation, however created or organized, is formed or availed of for the purpose of preventing the imposition of the surtax upon its shareholders through the medium of permitting its gains and profits to accumulate instead of being divided or distributed, there shall be levied, collected, and paid for each taxable year upon the net income of such corporation a tax equal to 50

per centum of the amount thereof, which shall be in addition to the tax imposed by section 230 of this title and shall (except as provided in subdivision (d) of this section) be computed, collected, and paid upon the same basis and in the same manner and subject to the same provisions of law, including penalties, as that tax.

"(b) The fact that any corporation is a mere holding or investment company, or that the gains or profits are permitted to accumulate beyond the reasonable needs of the business, shall be prima facie evidence of a purpose to escape the surtax.

"(c) When requested by the Commissioner, or any collector, every corporation shall forward to him a correct statement of such gains and profits and the names and addresses of the individuals or shareholders who would be entitled to the same if divided or distributed, and of the amounts that would be payable to each.

"(d) As used in this section the term 'net income' means the net income as defined in section 232, increased by the sum of the amount of the deduction allowed under paragraph (6) of subdivision (a) of section 234, and the amount of the interest on obligations of the United States issued after September 1, 1917, which would be subject to tax in whole or in part in the hands of an individual owner.

"(e) The tax imposed by subdivision (a) of this section shall not apply in respect of any taxable year if all the shareholders of the corporation include (at the time of filing their

returns) in their gross income their entire distributive share, whether distributed or not, of the net income of the corporation for such year. Any amount so included in the gross income of a shareholder shall be treated as a dividend received. Any subsequent distribution made by the corporation out of the earnings or profits for such taxable year shall, if distributed to any shareholder who has so included in his gross income his distributive share, be exempt from tax in the amount of the share so included."

The provisions of Section 104 of the Revenue Act of 1928 are as follows:

"(a) If any corporation, however created or organized, is formed or availed of for the purpose of preventing the imposition of the surtax upon its shareholders through the medium of permitting its gains and profits to accumulate instead of being divided or distributed, there shall be levied, collected, and paid for each taxable year upon the net income of such corporation a tax equal to 50 per centum of the amount thereof, which shall be in addition to the tax imposed by section 13 and shall be computed, collected, and paid upon the same basis and in the same manner and subject to the same provisions of law, including penalties, as that tax.

"(b) The fact that any corporation is a mere holding or investment company, or that the gains or profits are permitted to accumulate beyond the reasonable needs of the business, shall be prima facie evidence of a purpose to escape the surtax.

Exhibit 2.

"(c) As used in this section the term 'net income' means the net income as defined in section 21, increased by the sum of the amount of the dividend deduction allowed under section 23 (p) and the amount of the interest on obligations of the United States issued after September 1, 1917, which would be subject to tax in whole or in part in the hands of an individual owner.

"(d) The tax imposed by this section shall not apply if all the shareholders of the corporation include (at the time of filing their return) in their gross income their entire distributive shares, whether distributed or not, of the net income of the corporation for such year. Any amount so included in the gross income of a shareholder shall be treated as a dividend received. Any subsequent distribution made by the corporation out of the earnings or profits for such taxable year shall, if distributed to any shareholder who has so included in his gross income his distributive share, be exempt from tax in the amount of the share so included."

You will note from a review of the provisions of the statutes quoted above, the fact that your corporation has permitted its gains or profits to accumulate beyond the reasonable needs of its business is considered prima facie evidence of a purpose to prevent the imposition of the surtax upon its stockholders.

Before determining whether the provisions of Section 220 of the Revenue Act of 1926 and Section 104 of the Revenue Act of 1928 are applicable to your corporation for the fiscal year ended Jan-

uary 31, 1928, it is desired to extend to you full opportunity to be heard and to present by way of protest evidence to overcome the prima facie case created under the terms of the statutes.

In accordance with the foregoing, the matter will be held in abeyance for thirty days from the date of this letter within which time you may, if you desire, present a protest and show cause why the additional amount of taxes due under the provisions of the statutes quoted above should not be paid. If you desire a hearing on the matter, a request for such hearing should accompany your protest, and a hearing will be granted after the protest has been reviewed.

The statutory period of limitations applicable to the return filed for the fiscal year ended January 31, 1928, will expire on May 15, 1930. In view thereof, if you desire to file a protest and appear in a hearing upon the matter of applying the provisions of Sections 220 and 104, it is requested that the original and duplicate copies of the enclosed form of consent extending the period of limitations within which additional taxes may be assessed for that year until December 31, 1930, be immediately executed and forwarded to this office.

If no protest is filed within the period indicated, the audit of the case will be completed, and liability under Sections 220 and 104 of the Revenue Acts applicable to the period involved determined, and notice of the deficiency will issue as provided in Section 272 of the Revenue Act of 1928.

Respectfully,

DAVID BURNET,
Deputy Commissioner.

Enclosure:
Form of Consent.

Exhibit 2.

Exhibit F.

TREASURY DEPARTMENT
Washington

Office of
Commissioner of Internal Revenue
Address Reply to
Commissioner of Internal Revenue
and refer to
IT:E:RR
FMH

October 13, 1930.

National Grocery Company,
c/o McDermott, Enright and Carpenter,
75 Montgomery Street,
Jersey City, New Jersey.
Attention: Mr. John M. Enright.

Sirs:

Reference is made to your protest in the matter of the possible liability of your corporation for the fiscal year ended January 31, 1928, under the provisions of sections 220 and 104 of the Revenue Acts of 1926 and 1928, as indicated in office letter dated February 1, 1930.

You are informed that after carefully considering the facts contained in your protest and the additional facts disclosed at the hearing afforded your representatives on April 25, 1930, before the office of the General Counsel of the Bureau, the protest is sustained.

Accordingly, it is held that your company is not subject to taxation for the fiscal year ended January 31, 1928, under sections 220 and 104 of the Revenue Acts of 1926 and 1928.

Respectfully,

J. C. WILMER,
Deputy Commissioner.

Exhibit 3.

CERTIFICATE OF INCORPORATION

OF

NATIONAL GROCERY COMPANY

This is to certify, that the undersigned do hereby associate themselves into a corporation, under and by virtue of the provisions of an act of the legislature of the State of New Jersey, entitled "An act concerning corporations (Revision of 1896)," and the several supplements thereto and acts amendatory thereof, and do severally agree to take the number of shares of capital stock set opposite their respective names.

FIRST: The name of the corporation is the National Grocery Company.

Second. The location of the principal office in this state is at No. 450 Spring Street, West Hoboken, County of Hudson, N. J.

The name of the statutory agent therein and in charge thereof, and upon whom process against this corporation may be served, is Kenry Kleen.

Third. The objects for which this corporation is formed are to buy, sell and deal in groceries and vegetables of all kinds and conduct in all its branches the business of grocery men.

Fourth. The total authorized capital stock of this corporation is Five Thousand (5,000) Dollars, divided into fifty (50) shares of the par value of one hundred (100) dollars each.

Fifth. The names and post-offices of the incorporators and the number of shares subscribed for by each, the aggregate of such subscription being

the amount of capital stock with which the Company will commence business, are as follows:

Name	Post-Office Address	Number of Shares
Benjamin, Treacy,	15 Exchange Place, J. C.	4
Frank G. Smith,	548 Jersey Ave., J. C.	3
John J. Treacy,	657 Jersey Ave., J. C.	3

Sixth. The directors shall have power to make, alter and amend the by-laws of the Company.

In Witness Whereof, we have hereunto set our hands and seals the second day of June, A. D., 1908.

Benjamin Treacy
Frank G. Smith
John J. Treacy

Signed, Sealed and Delivered in the presence of I. F. Goldenhorn

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Certificate of Amendment of Charter.

National Grocery Company, a corporation of the State of New Jersey, by its President and Secretary, does hereby certify:—

I. That the principal office of the Company is at No. 320 First Street, Jersey City, New Jersey, and that the agent therein in charge thereof and upon whom process against the corporation may be served is Henry Kohl.

II. That the Board of Directors of said corporation at a meeting duly convened and held on the 28th day of August, 1911, passed a resolution declaring that the capital stock of said corpora-

tion be increased, and that the changes and amendments in the certificate of incorporation hereinafter set forth be advisable, and calling a meeting of the stockholders to take action thereon.

III. That a copy of said resolution of the board of directors is hereto appended.

IV. That thereafter on the 28th day of August, 1911, pursuant to such call of the board of directors, and upon waiver of notice of the time, place and purpose of such meeting, signed by all the stockholders, a special meeting of the stockholders of the company was held, at which meeting all the stockholders having voting powers were present in person, and that all the stockholders having voting powers voted in favor of such increase of capital and of such changes and amendments; such changes and amendments being as follows:

The amendment of the third article of said certificate of incorporation to read as follows:

"III. The objects for which this corporation is formed are to buy, manufacture, sell and deal in groceries, vegetables, meats, provisions, food products and kindred commodities, and conduct such business as wholesale or retail dealers in all branches."

The amendment of the fourth article of said certificate of incorporation to read as follows:

"IV. The corporation shall be authorized to issue capital stock to the extent of two hundred thousand dollars, divided into two thousand shares, of the par value of one hundred dollars each."

Exhibit 3.

The amendment of the sixth article of said certificate of incorporation to read as follows:

"VI. The board of directors shall have "power without the assent or vote of the "stockholders to make, alter, amend and "rescind the by-laws of this corporation, to "fix the amount to be reserved as working "capital, to authorize and cause to be exe- "cuted mortgages and liens without limit as "to amount upon the real and personal prop- "erty of this corporation.

"With the consent in writing and pursuant "to the vote of the holders of a majority of "the stock issued and outstanding, the direc- "tors shall have power and authority to sell, "assign, transfer or otherwise dispose of the "property of this corporation as an entirety.

"The directors may from time to time de- "termine whether and to what extent, and at "what times and places and under what con- "ditions and regulations, the accounts and "books of the corporation, or any of them, "shall be open to the inspection of the stock- "holders; but every stockholder shall have "the right of inspecting the stock and trans- "fer books of the corporation at all times "during business hours at the registered "office of the Company in New Jersey.

"The directors shall have power to hold "their meetings, to have one or more offices, "and to keep the books of the corporation "(except the stock and transfer books) out- "side of the State of New Jersey, at such "places as may be from time to time desig- "nated by them."

Exhibit 3.

The addition of article Seventh to said certificate of incorporation: Said article to read as follows:

"The following clauses shall be construed "both as objects and powers:

"(A) To manufacture, purchase, or other- "wise acquire goods, wares, merchandise and "personal property of every class and de- "scription, and to hold, own, mortgage, sell "or otherwise dispose of, trade, deal in and "deal with the same.

"(B) To acquire and undertake the good "will, property, rights, franchises and assets "of every kind and the liabilities of any per- "son, firm, association or corporation, either "wholly or partly, and to pay for the same in "cash, stock of the corporation, bonds, or "otherwise.

"(C) To enter into, make, perform and "carry out contracts of every kind and for "any lawful purpose with any person, firm, "association or corporation.

"(D) To borrow or raise money without "limit as to amount by the issue of or upon "debentures or debenture stock, or in such "other manner as the corporation shall think "fit.

"(E) To draw, make, accept, endorse, dis- "count, execute and issue promissory notes, "bills of exchange, warrants, bonds, deben- "tures and other negotiable or transferable "instruments.

"(F) To apply for, register, purchase or "otherwise acquire, and to hold, own, use and

"operate, and to sell, assign, grant licenses "in respect of, or otherwise dispose of and "deal with and turn to account any and all "inventions, improvements, formulae, proc- "esses, tradenames and trademarks, copy- "rights, letters patent of the United States "and of any or all foreign countries, and "patent rights of all kinds.

"(G) To conduct business in any of the "states, territories, colonies or dependencies "of the United States, in the District of "Columbia, and in any and all foreign coun- "tries, to have one or more offices therein, to "hold, purchase, mortgage and convey real "and personal property, without limit as to "amount, in any such state, territory, colony, "dependency, district or foreign country, but "always subject to the laws thereof.

"(H) To remunerate any person or corpo- "ration for services rendered, or to be ren- "dered, in placing or assisting to place or "guaranteeing the placing of any of the "shares of stock of the corporation, or any "debentures or other securities of the corpo- "ration, or in or about the formation or pro- "motion of the corporation or in the conduct "of its business.

"(I) To do any or all of the things herein "set forth to the same extent as natural per- "sons might or could do, and in any part of "the work.

"(J) In general, to carry on any other "business in connection with the foregoing, "whether manufacturing or otherwise, and "to have and to exercise all the powers con-

Exhibit 3.

"ferred by the laws of New Jersey upon cor-
"porations formed under the act hereinafter
"referred to: It being

"hereby expressly provided that the fore-
"going enumeration of specific powers shall
"not be held to limit or restrict in any man-
"ner the powers of the corporation."

IV. That at said meeting of the stockholders the foregoing increase of capital stock, amendments and changes in the certificate of incorporation were assented to in writing by all the stockholders having voting powers, which said written assent is hereto appended.

V. That twenty shares of stock of said corporation are issued and outstanding.

IN WITNESS WHEREOF the said National Grocery Company has caused this certificate to be signed by its President and its Secretary, and its corporate seal to be hereunto affixed this 28th day of August nineteen hundred and eleven.

NATIONAL GROCERY COMPANY,

By HENRY KOHL,
President

ANNA L. MULLINS,
Secretary

(Corporate Seal)

Exhibit 4.

Statement of Stores, Taxes, Earnings, etc., '08 to '35.

(*Opposite* ☞)

Number Stores	Henry Kohl's Salary	Personal Income Taxes Paid by Mat. Gro. Co.	Net Profits of Books after deducting Henry Kohl's Salary and Federal Income Taxes	Dividends Declared to Henry Kohl	Net Additions to Capital and Surplus	Other Taxes Real Estate, Personal, etc.	Henry Kohl's Personal Income Tax
12/31/1906			$16359 07		$16359 07		
3	$3125 00		4584 39		4584 39		
11	3380 00		7968 68		7968 68		
23	3380 00		40806 96		40806 96		
39	3380 00		58601 38		58601 38		
57	4955 00	$899 31	74931 22		74931 22		
81	5200 00	1932 67	66989 90		66989 90	$1799 43	
104	6450 00	3593 85	101954 66		101954 66	1898 87	
134	10400 00	3647 66	173180 81		173180 81	7956 20	
171	10400 00	2200 66	124451 65		124451 65	6169 54	$64 00
217	15000 00	16621 91	235885 21	$25000 00	210885 21	6090 02	64 00
268	20300 00	270734 95	584841 59		584841 59	6983 95	110 00
290	20800 00	242446 98	274249 13	25000 00	249249 13	11431 86	203 00
310	31200 00	284430 80	323932 24		323932 24	17712 39	1877 44
344	5620 00	133374 32	254156 70		254156 70	23986 18	7755 19
358	50400 00	91526 44	324908 63		324908 63	27721 72	2653 91
388	52000 00	77996 71	461106 88		461106 88	28804 00	7176 02
448	52000 00	79701 44	547483 80		547483 80	31447 00	6419 16
482	54000 00	76248 30	528022 34		528022 34	33999 67	7106 41
535	10000 00	73510 07	508837 06		508837 06	35800 31	5090 87
625	106000 00	74437 56	498879 08		498879 08	34907 47	12689 10
715	104000 00	111828 03	707239 60		707239 60	46411 63	12826 68
782	104000 00	100437 42	769945 96		769945 96	55293 41	12055 85
799	104000 00	93534 11	713181 62		713181 62	57303 14	11636 44
815	104000 00	103316 60	682850 38		682850 38	36371 87	10946 49
	$1026570 00	$1842719 79	$6085348 94	$50000 00	$8035348 94	$472088 66	11140 84
							$109815 40
819	104000 00	28845 43	525947 67	100000 00	425947 67	56786 87	
815	89500 00	11249 15	132991 35	100000 00	32991 35	61003 04	32034 74
816	84000 00	5842 03	111211 91	100000 00	11211 91	92833 21	60022 48
808	72500 00	53903 37	368685 50	300000 00	68685 50	72995 04	40881 84
792	78000 00	17993 85	202545 99	200000 00	2545 99	60905 28	54916 44
							109443 52
	1424570 00	$1960653 62	$9426731 36	$850000 00	$8576731 36	$816612 10	$407114 42

Recapitulation Total Taxes paid U.S. Govr. $2,367,768.04

" Salaries " Henry Kohl 1,424,570.00

" Dividends " " " 850,000.00

$2,274,570.00

Exhibit 5.

Analysis of Surplus.

(*Opposite* ☞)

National Grocery Co.

Exhibit E
Surplus - Analysis

	1/31/13	1/31/14	1/31/15	1/31/16	1/31/17	1/31/18	1/31/19	1/31/20	1/31/21	1/31/22
Opening Balance	3,251.70	70,241.60	172,196.26	345,377.07	489,050.62	740,765.37	1,400,323.66	1,649,804.65	2,025,305.56	2,241,061.44
Taxable Net Income	66,989.90	101,954.66	173,180.81	143,673.55	276,714.75	659,558.49	374,480.79	325,958.24	400,061.89	488,816.22
Non-taxable "									6,609.00	9,316.00
Income Tax Refund										
Credit Balances of Reserves Returned to Surplus including Liability 1920 Income tax set up as Reserve								100,000.00		
Totals	70,241.60	172,196.26	345,377.07	489,050.62	765,765.37	1,400,323.66	1,674,804.65	2,075,762.89	2,432,175.89	2,739,193.66
Income Taxes Paid									191,625.00	80,000.00
Addl " " "								48,251.35		
Dividends					25,000.00		25,000.00			
Reserve Charges During Year										
Donations									9,470.00	
Tax Reserve Set Up										219,268.14
Closing Balance	70,241.60	172,196.26	345,377.07	489,050.62	740,765.37		1,649,804.65	2,025,305.56	2,241,061.44	2,438,441.66
Totals	70,241.60	172,196.26	345,377.07	489,050.62	765,765.37	1,400,323.66	1,674,804.65	2,075,762.89	2,432,175.89	2,739,193.66

1/31/[illegible]	1/31/25	1/31/26	1/31/27	1/31/28	1/31/29	1/31/30	1/31/31	1/31/32
2,341,031.44	2,406,641.42	2,975,174.86	4,039,345.86	4,682 7.14	5,068,401.44	5,660,953.49	6,425,846.55	7,226,535.51	8,048,330.86	8,909,274.72
485,218.82	622,975.07	697,611.80	608,811.04	5819.04	551,369.35	856,097.80	848,920.05	848,111.80	833,471.87	841,211.91
9,316.00	44,370.21	51,888.80	55,141.82	6188.08	97,666.84	98,769.64	90,668.74	99,587.80	92,060.44	98,444.82
	804.41				41,250.98					
		466,005.84								
2,705,615.68	3,074,009.97	4,089,348.88	4,682,798.17	5,514.26	5,718,708.56	6,545,880.63	7,369,235.34	8,167,972.41	9,003,868.97	9,248,930.84
80,886.06	68,697.85		89,886.06	6188.14	67,868.68	66,607.80	110,808.94	100,196.96	95,825.70	109,888.81
				11750.68	226.45	53,566.80	81,897.89	19,442.59	1,288.86	
	180,167.88									109,000.08
219,288.14										
2,406,641.42	2,975,174.86	4,089,348.88	4,682,201.14	5,0[illegible]401.44	5,660,953.49	6,425,846.55	7,226,535.51	8,048,330.86	8,909,274.72	9,045,105.88
2,705,615.68	3,074,009.97	4,089,348.88	4,682,798.17	5514.26	5,718,708.56	6,545,880.63	7,369,235.34	8,167,972.41	9,003,868.97	9,248,930.84

Exhibit 6.

Balance Sheet 1907–1935.

(*Opposite* ☞)

year ending	1907 2/1/08	1908 2/6/09	1909 2/5/10	1910 2/4/11	1911 2/10/12	1912 2/8/13	1913 2/9/14	1914 2/8/15	1915 2/5/16	1916 2/3/17	1917 2/2/18
ASSETS											
Cash			$ 3,322.63	$ 409.86	$ 6,692.61	$ 22,522.03	$ 14,459.56	$ 60,733.52	$ 71,203.04	$ 103,302.43	$ 89,461.85
Notes Receivable					50.00	50.00	950.00		1,500.00	1,350.00	25,350.00
Accounts Receivable	$ 7,176.56	$ 1,126.89	4,344.04	11,352.68	1,067.29	2,500.24	223.86	2,493.97	10,175.02	14,138.85	12,074.05
Inventories	23,498.13	38,652.31	62,447.52	116,555.87	165,456.44	246,115.08	320,778.62	411,686.87	386,962.06	630,417.84	1,137,595.29
Mortgage											
Bonds											20,000
Stocks	750.00	750.00	750.00	1,150.00	1,250.00	800.00	800.00	800.00	44,700.00	44,700.00	44,700.00
Other											
Deferred			1,113.00	1,633.50			850.00	742.00	776.00		
Permanent	6,991.20	8,204.01	14,527.72	31,673.53	108,579.46	217,435.76	243,009.38	257,377.60	281,385.03	393,438.17	412,260.49
TOTAL	38,415.89	48,733.21	86,504.91	162,777.44	283,095.80	489,423.11	581,071.42	733,833.96	796,701.15	1,187,347.29	1,741,441.68
LIABILITIES											
Notes Payable & Mtge	7,000.00	12,000.00	15,500.00	32,000.00	68,500.00	195,001.00	170,500.00	153,500.00	106,000.00	240,000.00	165,000.00
Accounts Payable	10,472.43	3,956.36	1,285.81	2,456.96	11,344.10	24,180.51	38,375.16	25,836.87	2,862.39	25,030.36	39,790.21
Accrued								115.00			
Reserve Income Tax											
Reserve Insurance										2,250.50	9,120.00
Reserve Deprec. Acct								9,005.02	18,010.04	39,352.50	61,975.95
Reserve for Profit Sharing Coupons											
Reserve for Sales Tax—N. Y. C.											
Reserve for Dividends											
Capital Stock & Surplus	20,943.46	32,776.85	69,719.10	128,320.48	203,251.70	270,241.60	372,196.26	545,377.07	669,828.72	880,713.93	1,465,555.52
RESERVE FOR UNEMPLOY. INS.											
TOTAL	$38,415.89	$48,733.21	$86,504.91	$162,777.44	$283,095.80	$489,423.11	$581,071.42	$733,833.96	$ 796,701.15	$1,187,347.29	$1,741,441.68

NATIONAL GROCERY COMPANY

Balance Sheets from 1907 to 1935

1917 2/2/18	1918 2/1/19	1919 2/1/20	1920 1/31/21	1921 1/31/22	1922 1/31/23	1923 1/31/24	1924 1/31/25	1925 1/31/26	1926 1/31/27	1927 1/31/28	1928 1/31/29
$ 89,461.85	$ 250,515.92	$ 224,313.01	$ 411,961.22	$ 556,264.77	$ 360,422.28	$ 507,409.84	$ 761,107.48	$ 645,982.83	$ 554,601.46	$ 659,734.40	$ 890,397.59
25,350.00				126,000.00			389,100.00	409,100.00	424,100.00	424,100.00	460,000.00
12,074.05	27,216.74	29,532.06	29,610.92	5,405.90	384,991.71	5,188.07	3,711.88	3,057.72	2,901.52	1,888.82	3,975.19
1,137,595.29	1,387,807.01	1,844,475.02	1,726,179.36	1,489,129.24	1,640,084.48	1,869,773.06	2,022,538.53	2,268,013.75	2,572,713.23	2,615,057.67	2,917,716.55
					2,000.00	2,000.00	42,000.00	42,000.00	84,000.00	59,000.00	59,000.00
20,000	47,500.00	80,000.00	80,000.00	490,000.00	476,759.50	1,024,631.53	1,084,186.35	846,960.33	602,572.46	256,114.76	96,820.30
44,700.00	44,700.00	44,700.00	57,850.00	130,710.00	341,176.41	347,331.25	422,025.55	751,076.43	840,621.25	2,169,687.62	2,318,074.13
						114,782.02	17,598.59	55,493.00	9,092.37	6,236.39	7,425.08
						20,738.55	23,796.53	27,457.85	36,150.32	33,338.64	25,685.23
412,260.49	523,913.79	553,917.76	562,206.03	552,387.34	548,338.64	382,173.44	442,022.53	542,448.47	1,391,132.94	1,542,129.60	1,501,193.83
1,741,441.68	2,281,653.46	2,776,937.85	2,867,807.53	3,349,897.25	3,753,773.02	4,274,027.76	5,208,087.44	5,591,590.38	6,517,885.55	7,767,287.90	8,280,287.90
165,000.00	350,000.00	373,100.00	26,000.00	20,250.00	14,750.00	14,750.00	361,250.00	211,250.00	558,750.00	1,008,750.00	700,000.00
39,790.21	96,732.65	103,361.51	134,396.34	151,631.29	10,597.21	159,258.75	159,784.30	243,273.25	227,066.53	258,889.61	270,318.54
	9,005.00	7,251.00	840.00	166.50	268.50	2,926.57	2,126.92	3,263.45	4,672.01	7,742.15	7,385.56
		100,000.00	200,000.00	250,000.00	250,000.00	250,000.00	225,000.00	106,249.32	147,500.25	93,933.45	72,035.56
9,120.00	19,991.00	30,250.00	52,184.04	78,472.52	123,701.62	183,969.81	251,788.00	296,546.99	351,136.56	417,797.77	491,032.34
61,975.95	91,120.16	124,238.45	161,493.56	199,038.05	237,853.01						
1,465,555.52	1,714,804.65	2,038,736.89	2,292,893.59	2,650,338.89	3,116,602.68	3,663,122.63	4,208,138.22	4,731,007.37	5,228,760.20	5,980,174.92	6,739,515.90
$1,741,441.68	$2,281,653.46	$2,776,937.85	$2,867,807.53	$3,349,897.25	$3,753,773.02	$4,274,027.76	$5,208,087.44	$5,591,590.38	$6,517,885.55	$7,767,287.90	$8,280,287.90

1927 1/31/28	1928 1/31/29	1929 1/31/30	1930 1/31/31	1931 1/31/32	1932 1/31/33	1933 1/31/34	1934 1/31/35	1935 1/31/36
$ 659,734.40	$ 890,397.59	$1,332,332.28	$1,405,961.04	$1,130,286.72	$ 857,497.07	$ 625,310.20	$ 939,782.77	$ 934,079.61
424,100.00	460,000.00	470,000.00	610,000.00	550,000.00	525,000.00	436,000.00	435,000.00	443,500.00
1,888.82	3,975.19	26,816.37	3,220.85	14,553.14	44,644.02	66,100.66	65,617.68	57,250.76
2,615,057.67	2,917,716.55	3,189,396.72	2,812,939.16	2,215,218.27	2,012,375.67	2,161,902.11	2,155,654.07	2,195,301.56
59,000.00	59,000.00	59,000.00	59,000.00	59,000.00	57,000.00	57,000.00	57,000.00	57,000.00
256,114.76	96,820.30	59,435.00	313,391.27	1,036,265.92	1,518,642.98	1,978,999.32	2,199,089.43	2,340,632.49
2,169,687.62	2,318,074.13	2,720,283.07	2,676,061.47	3,073,803.72	3,285,527.08	3,121,890.26	3,072,055.86	3,235,204.77
6,236.39	7,425.08	10,150.89	20,686.18	28,622.17	34,249.25	45,191.58	25,564.23	26,526.18
33,338.64	25,685.23	31,875.79	29,687.74	26,932.68	71,595.24	76,627.51	27,699.32	27,807.93
1,542,129.60	1,501,193.83	1,345,976.63	1,177,489.43	1,358,482.91	1,247,196.34	1,186,333.73	1,082,889.00	999,323.87
7,767,287.90	8,280,287.90	9,245,266.75	9,108,437.14	9,493,165.53	9,653,727.65	9,755,355.37	10,060,352.36	10,316,627.17
1,008,750.00	700,000.00	790,000.00						100,000.00
258,889.61	270,318.54	371,121.96	269,140.49	230,453.33	229,243.90	232,822.88	287,730.15	321,597.16
7,742.15	7,385.56	19,757.11	7,411.70	9,171.47	9,376.37	10,243.26	4,185.86	3,420.65
93,933.45	72,035.56	52,592.97	51,330.42	51,122.01	44,255.43	46,318.48	46,318.48	46,318.48
417,797.77	491,032.34	565,970.45	641,588.99	712,176.68	788,131.46	851,868.96	909,115.64	959,929.16
					74,147.37	84,759.89	84,759.89	84,759.89
							153.60	4,087.76
							100,000.00	200,000.00
5,980,174.92	6,739,515.90	7,445,824.26	8,138,965.54	8,490,242.04	8,508,573.12	8,529,341.90	8,628,088.74	8,594,725.21
								1,788.86
$7,767,287.90	$8,280,287.90	$9,245,266.75	$9,108,437.14	$9,493,165.53	$9,653,727.65	$9,755,355.37	$10,060,352.36	$10,316,627.17

Exhibit 7.

No. of Stores, Sales, Profits '07–'35.

(*Opposite* ☞)

4/29/36

NATIONAL GROCERY COMPANY

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Yr.	Yr. End. Jan. 31	Number of Stores Operated	Over Preceding Yr. Inc.	Over Preceding Yr. Dec.	Gross Sales	Net Profits per Book	Net Taxable Income
1907-	1908	3	-	-	$181028 11	$4584 39	
1908-	1909	11	8	-	267377 56	7968 68	
1909-	1910	23	12	-	601350 44	40806 96	
1910-	1911	39	16	-	975532 76	58601 38	
1911-	1912	57	18	-	1387924 15	74931 22	
1912-	1913	81	24	-	1899315 40	66989 90	$66989 90
1913-	1914	104	23	-	2603211 48	101954 66	101954 66
1914-	1915	134	30	-	3446212 84	173180 81	173180 81
1915-	1916	171	37	-	3924321 68	124451 65	143673 55
1916-	1917	217	46	-	5493394 70	235885 21	276714 75
1917-	1918	268	51	-	8749196 50	584841 59	659558 49
1918-	1919	290	22	-	10623466 32	274249 13	274480 79
1919-	1920	310	20	-	12602935 14	323932 24	323932 24
1920-	1921	344	34	-	15036341 52	254156 70	400061 39
1921-	1922	358	14	-	13542175 60	324908 63	455218 22
1922-	1923	388	30	-	13721399 46	529774 41	623973 67
1923-	1924	448	60	-	15378387 45	584213 53	637611 50
1924-	1925	482	34	-	15973716 30	581745 32	608311 07
1925-	1926	535	53	-	17321525 50	576592 13	561919 04
1926-	1927	625	90	-	19239740 66	565507 90	551389 35
1927-	1928	715	90	-	22125013 40	818043 54	836097 50
1928-	1929	782	67	-	24116343 72	870144 92	842920 05
1929-	1930	799	17	-	26376787 91	806507 32	843916 75
1930-	1931	815	16	-	25142537 41	786466 98	863471 67
1931-	1932	819	4	-	21261618 88	268399 34	152925 43
1932-	1933	815	-	4	18662144 45	147276 51	176284 50
1933-	1934	816	1	-	18151322 23	135053 94	42487 46
1934-	1935	808	-	8	19250911 06	422588 87	456483 80
1935-	1936	792	-	16	18709589 97	220539 84	197391 22

as reported on Federal Income Tax returns

Page Tightly Bound

Exhibit 8.

INFORMATION REGARDING STORES

NATIONAL GROCERY COMPANY — MAY 1st, 1936

Year	Yr. Ending Jan./Feb.	Stores Opened	Stores Closed	Net	No. of Stores in Operation at Close of Fiscal Year
1925	1926	72	19	53	535
1926	1927	90	—	90	625
1927	1928	98	8	90	715
1928	1929	83	16	67	782
1929	1930	33	16	17	799
1930	1931	27	11	16	815
1931	1932	28	24	4	819
1932	1933	8	12	4	815
1933	1934	14	13	1	816
1934	1935	2	10	8	808
1935	1936	5	21	16	792

Exhibit 9.

WAGES AND NUMBER OF EMPLOYEES.

NATIONAL GROCERY COMPANY — APRIL 28, 1936

Year	No. Employees	Total Wages Paid Employees
1924-1925 yr. ending	1462	$ 1,683,947.70
1925-1926 " "	1597	1,873,338.59
1926-1927 " "	1819	2,171,018.69
1927-1928 " "	2041	2,449,278.66
1928-1929 " "	2210	2,825,615.53
1929-1930 " "	2264	2,922,847.30
1930-1931 " "	2332	3,132,891.99
1931-1932 " "	2234	2,932,823.39
1932-1933 " "	2115	2,525,523.37
1933-1934 " "	2022	2,399,544.89
1934-1935 " "	2161	2,506,250.60
1935-1936 " "	2098	2,540,832.28
		$29,963,912.99

Exhibit 10.

Purchases, Discounts, Rents '25–'35.

(*Opposite* ☞)

5/4/36

NATIONAL GROCERY COMPANY E 10

YEAR	ENDING		PURCHASES	DISCOUNTS	RENTS
1925	1/31/26	PURCHASE	13653857.15	157586.10	479780.84
1926	1/31/27	DISCOUNT DED-	15077858.66	168991.45	503044.13
1927	1/31/28	UCTED FROM	17158300.86	185030.60	739514.24
1928	1/31/29	INSTEAD OF	18744424.95	217018.02	878026.79
1929	1/31/30	BEING INCLUD-	20737355.71	201667.15	923841.51
1930	1/31/31	ED AS DISCOUNTS	19993937.83	493719.24	929918.70
1931	1/31/32	PURCHASE DIS-	16761471.48	434114.20	914589.22
1932	1/31/33	COUNT NOT DE-	14774997.00	426801.65	850981.73
1933	1/31/34	DUCTED FROM	14205547.66	319301.26	759154.85
1934	1/31/35	PURCHASES BUT	15038194.89	307966.89	692317.75
1935	1/31/36	ARE INCLUDED IN DISCOUNTS	14818165.52	327333.25	657365.03

Exhibit 11.

NATIONAL GROCERY COMPANY

NOTES RECEIVABLE

(All made by Henry Kohl. No interest ever paid, charged or accrued on the books)

Jan. 18, 1922	$26,000	Int. 6%	26,000	end of fiscal year ending 1/31/22	
Dec. 21, 1922	10,000	Int. 6%	36,000	end of fiscal year ending 1/31/23	
May 8, 1923	23,100	Int. 6%			
May 10, 1923	25,000	" "			
Dec. 14, 1923	5,000	" "			
Jan. 24, 1924	5,000	" "	94,100	end of fiscal year ending 1/31/24	
Mar. 8, 1924	5,000	Int. 6%			
June 18, 1924	15,000	" "			
June 28, 1924	25,000	" "			
Aug. 25, 1924	25,000	" "			
Sept. 29, 1924	155,000	" "			
Oct. 23, 1924	10,000	" "			
Dec. 12, 1924	25,000	" "			
Jan. 5, 1925	10,000	" "			
Jan. 16, 1925	25,000	" "	389,100	end of fiscal year ending 1/31/25	
Jan. 26, 1925	5,000	Int. 6%			
May 9, 1925	10,000	No interest			
June 15, 1925	5,000	" "	409,100	end of fiscal year ending 1/31/26	
Mar. 23, 1926	10,000	No int.			
May 3, 1926	25,000	" "	444,100		
		Pd.	20,000	Sept. 26, 1926; $100 pd. 8/25/32	
			424,100	end of fiscal year ending 1/31/27	
			424,100	end of fiscal year ending 1/31/28	
July 3, 1928	15,900	No Int.	Pd.	8/25/32	
Dec. 26, 1928	10,000	" "	"	8/25/32	
Jan. 22, 1929	10,000	" "	"	8/25/32	
			460,000	end of fiscal year ending 1/31/29	
Dec. 17, 1929	10,000	No int.	Pd.	8/25/32	
			470,000	end of fiscal year ending 1/31/30	
Apr. 21, 1930	30,000	No int.	Pd.	11,000 5/24/33—Pd. 19,000 8/25/32	
June 16, 1930	10,000	" "	"	5/24/33	
Jan. 9, 1931	100,000	" "	"	$60,000 3/17/31—Pd. $40,000 5/24/33	
			610,000	end of fiscal year ending 1/31/31	
Mar. 17, 1931			Pd.	60,000	
			550,000	end of fiscal year ending 1/31/32	
Mar. 15, 1932	25,000	" "	575,000	(Pd. 5/24/33)	
Aug. 25, 1932			65,000	Pd.	
			510,000	end of fiscal year ending 1/31/33	
May 24, 1933			86,000	Pd.	
			424,000	still owing 4/28/36	

Exhibit 12.

Application of Dividends to Loans.

(*Opposite* ☞)

NATIONAL GROCERY COMPANY

MAY 2ND 1936

STATEMENT SHOWING APPLICATION OF DIVIDENDS TO LOANS

DIVIDENDS DECLARED AMOUNT	PAID TO MR. HENRY KOHL	PAYMENTS BY - MR. HENRY KOHL TO NATIONAL GROCERY CO. ON NOTES
DEC. 5TH 1916-$25,000.00	2/3/17 BY CHECK	
APR. 9TH 1918-$25,000.00	4/9/18 BY CHECK	
MAR. 23RD 1931-$100,000.00	3/17/31-$40,000.00 BY CHECK	$20,000.00 (CHECK) 9/4/26 $60,000.00 (BY ENTRY 3/20/31)
		$65,000.00 (LOAN FROM BANK) 8/25/32
DEC. 30TH 1932-$100,000.00	12/30/32 BY CHECK	
MAY 23RD 1933-$100,000.00	5/24/33 BY CHECK	$86,000.00 (CHECK) 5/24/33
MAR. 8TH 1934-$100,000.00	3/9/34-$50,000.00 BY CHECK	
	6/14/34-25,000.00 " "	
	12/10/34-25,000.00 " "	
JAN. 16TH 1935-$200,000.00	1/29/35-$100,000.00 BY CHECK	
	4/18/35-$100,000.00 " "	
JAN. 23RD 1936-$200,000.00	3/14/36-$25,000.00 BY CHECK	
	4/13/36-$75,000.00 " "	
	5/15/36-BALANCE WILL BE PAID.	

Exhibit 13.

BASIS FOR INSURANCE RESERVES YEAR ENDING JANUARY 31, 1931

We credited our self insurance reserve with the following for the period February 1st, 1930 to February 1st, 1931—800 stores.

$3,200 Fire, merchandise and fixtures	@	$18.20	$14,560.00
Public Liability and Property Damage	@	10.00	8,000.00
$1,000 Bond (Fidelity)	@	7.50	6,000.00
$2,000 Burglary, merchandise and cash	@	12.50	20,000.00
		per M	
Hold-up	@	6.60	5,280.00
Plate Glass	@	17.00	13,600.00
Forgery Bond (200M)			1,000.00
Motors against burnout and mechanical accidents			423.54
Full coverage collision on all automobiles			8,933.35
Sprinkler leakage—300 Mercer St. 2½% Co. Inc. clause — stock 500M 2½% or 12,500	@	1.47	183.75
			$77,980.64
Prod. Liability—Premium based on output figures			$ 1,248.37
Mdse. in transit—Premium based on output figures (all risks)			2,510.69
			$ 3,759.06

CAFETERIA

Fire	$ 11.35
Bond	3.75
Burglary	12.50
	$ 27.60
GRAND TOTAL	$81,767.30

Exhibit 14.

Notes Payable 1925–date.

(*Opposite* ☞)

NATIONAL GROCERY COMPANY
NOTES PAYABLE 1/24/25 TO DATE

Yr. Ending	Period	Amount	Rate Interest
1924-1/31/25		350000 00	3%
	2/21/25	150000 00	"
	3/22/25	100000 00	4½%
	10/3/25	100000 00	4½%
	10/31/25	100000 00	"
	11/28/25	300000 00	4½-4½%
	12/26/25	300000 00	"
1925-1/31/26		200000 00	4½-4½%
	8/7/26	600000 00	4½-4%
	9/4/26	600000 00	"
	10/2/26	600000 00	"
	10/30/26	800000 00	4½-4½-4%
	11/27/26	800000 00	"
	12/25/26	800000 00	"
1926-1/31/27		550000 00	4½-4½%
	2/26/27	550000 00	"
	5/21/27	400000 00	"
	7/16/27	250000 00	4½%
	8/13/27	750000 00	4½-3½%
	10/8/27	500000 00	4½-3½%
	11/5/27	700000 00	4½-3½%
	12/31/27	1000000 00	4-4½-3½%
1927-1/31/28		1000000 00	"
	2/25/28	900000 00	"
	3/24/28	600000 00	4-3½%
	4/21/28	400000 00	3½%
	7/14/28	700000 00	4½-4%
	8/11/28	1000000 00	4½-4½%
	12/1/28	900000 00	5½-5%
1928-1/31/29		700000 00	5½%
	3/23/29	500000 00	"
	6/15/29	800000 00	"
	8/10/29	990000 00	"
1929-1/31/30		790000 00	"
	2/22/30	390000 00	"
	3/22/30	190000 00	"
	4/19/30	NONE	
1930-1/31/31		NONE	
1931-1/31/32		NONE	
1932-1/31/33		NONE	
	7/15/33	200000 00	2%
	9/9/33	300000 00	"
	12/2/33	205000 00	"
	12/30/33	100000 00	"
1933-1/31/34		NONE	
1934-1/31/35		NONE	
	11/2/35	200000 00	1½%
1935-1/31/36	3/21/36	100000 00 200000 00	" "

Exhibit 15.

Table to show depreciation shown on annexed sheets.

$2,859,217.25	Market 1/31/30.
479,160.33	Plus securities bought during year.
$3,338,377.58	Total.
269,425.66	Less securities sold (cost) during year.
$3,068,951.92	
2,125,434.50	Market 1/31/31.
$ 943,517.42	Depreciation.

(*Opposite* ☞)

HOLDINGS - JANUARY 31,1930 — NATIONAL GROCERY COMPANY — HOLDINGS - JANUARY 31, 1931

	SECURITY - STOCKS	NO. OF SHARES	PRICE 1/25/30	MARKET VALUE 1/25/30	UNIT COST	COST	PURCHASES AFTER 1/25/30			SOLD BEFORE 1/25/31		NO. OF SHARES	PRICE 1/31/31	MARKET VALUE 1/31/31
	INDUSTRIALS													
(A)	Adams Express Co.	562-1/2	26-1/2	14906	44	24,722.50	3 25	1/10 share				662	21-1/4	14067
	American Can Co.	300	128	38400	119-1/8	35,737.50	12375 00	100 shs		35737 50	300 shs	100	113	11300
	American Cyanamid B.	50	27-1/2	1375	53-1/2	2,671.25						50	9-3/8	469
	American Express Co.	250	210-361	52500	323-1/2	80,862.50						250	177-675	44250
	Allis Chalmers Co.	400	55-1/2	27750	65-1/2	26,220.00						400	36-1/2	14600
	Aviation Corp.	150	5	750	10	1,507.50						150	4-3/8	655
	Aluminum Co. of Amer. pfd.						10925 00	100 shs				100	108½-109	10850
	American Machine & Foundry Co.	35	217-3/4	7621 25	197	6,895.00				6895 00	35 shs			
	Borden Co.	103-45/100	66-1/2	6883	88-1/2	9,154.35		3-9/100 S.D.		-	45/100	106-9/100	69	7320
	Byers A.M.Co.	200	91	18200	141-3/8	28,281.25						200	42-1/4	8450
	Case Co. J.I.	100	224	22400	282	28,195.50	11102 50	50 shs				150	92-1/4	13838
	Chrysler Corp.	200	35-3/4	7150	54-5/8	10,932.50						200	18	3600
	Columbian Carbon Co,	75	179-3/4	13481	182-3/8	13,681.25						75	84	6300
	Columbia Graphophone Co.Ltd.	400	27-7/8	15148	64-7/8	25,952.15						400	8-7/8	3548
	Curtis Aero & Motor Co.	100	no price available		132-1/4	13,225.00						100	no price available	
	Curtis Wright Corporation	300	7-1/8	2136	12-1/2	5,737.50						300	4-1/4	1275
	Cushman Sons Corporation.	150	no price available		212-1/4	31,832.50						150	no price	available
XAXX	Consolidated Electric Sign Co.	-	no price available		-	6,732.26				6732 26	-			
	Commercial Solvents Corp.						12807 50	6 shs S.D. 500 shs				506	18-1/4	9235
	Eastman Kodak Co.						11702 50	50 shs				50	155	7750
	Butterick Co.	500	18	9000	49-3/8	24,805.00						500	15	7500
(B)	Fokker Aircraft Corp.	100	15-1/2-16	1550	41	4,090.00								
(C)	General Aviation Corp.											100	6-5/8-6/7/8	662
	General Baking Common	441	3-5/8	1596								441	5/8	273
	General Baking Co. 8% pfd.	9	123-1/4-123½	1109	00	900.00						9	107-110	963
	General Baking Corp.6% pfd.	126	49	6174								126	29-1/2	3717
(D)	General Electric Co.	100	260-3/4	26075	384-7/8	38,488.75						400	45-1/4	18100
	Gobel Adolph Inc.	200	16	3200	56	11,210.00						200	6-3/8	1274
	Gold Dust Corp.	500	44-3/4	22375	72	35,994.65						500	34-1/2	17250
	Great A. & P. Tea Co.	10	235-1/4	2352	370-1/2	3,705.00						10	210	2100
(E)	Houston Oil Co.	200	58-1/2	11700	97-5/8	19,520.00		80 shs S.D.				880	9-3/8	8250
	Hudson Bay Mining & Smelt.Co.	200	11-1/2	2300	15-7/8	3,170.00						200	4-7/8	974
	International Match Corp. pfd.	200	72-1/2	15100	90-1/4	18,040.00						200	58-3/4	11750
	Journal Square Hotel Corp.units	125	no price available		20	2,500.00				2500 00	125 units			
	Loft Inc.						3075 00	1000 shs				1000	3-1/2	3500
	Marmon Motor Car Co.	300	23-7/8	7161	92-3/4	27,835.00		6 shs S.D.				305	6-1/2	1989
	Montgomery Ward & Co.	500	44-1/4	22125	121-3/8	60,655.00						500	18-5/8	9310
	National Distillers Prod.Corp.						3340 00	100 shs				100	26	2600
	Phelps Dodge Corp.	100	40.	4000	86	8,595.00						100	21	2100
	Petroleum Derivatives Inc.	100	11½ - 13½	1150	61-1/4	6,125.00						100	2½ - 5	250
	Phillips Petroleum Co.						11032 50	300 shs				300	13-3/8	4011
	Radio B. pfd.	100	69-7/8	6987	80-1/4	8,020.00						100	41-1/8	4112
	Radio Corp. common	100	38-1/4	3825	45	4,490.00				4490 00	100 shs			
	Remington Arms Corp.	100	off 30	3000	37-1/8	3,715.00						100	12-15 a	1200
	options in syndicate	TOTAL		379,479.25		634,198.91	76,365.26			56,354.76				251,391.00

HOLDINGS - JANUARY 31, 1931

NO. OF SHARES	PRICE 1/31/31	MARKET VALUE 1/31/31	UNIT COST	COST
662	21-1/4	14067	42-3/8	28,025.75
100	113	11300	123-3/4	12,375.00
50	9-3/8	469	53-1/2	2,671.25
250	177-675	44250	323-1/2	80,862.50
400	36-1/2	14600	65-1/2	26,220.00
150	4-3/8	655	10	1,507.50
100	108½-109	10850	109-1/4	10,925.00
106-9/100	69	7320	86-3/8	9,154.35
200	42-1/4	8450	141-3/8	28,281.25
150	92-1/4	13838	262	39,298.00
200	18	3600	54-5/8	10,932.50
75	84	6300	182-3/8	13,681.25
400	8-7/8	3548	64-7/8	25,952.15
100	no price available		132-1/4	13,225.00
300	4-1/4	1275	12-1/4	5,737.50
150	no price available		212-1/4	31,832.50
506	18-1/4	9235	25-3/8	12,607.50
50	155	7750	234	11,702.50
500	15	7500	49-5/8	24,805.00
100	6-5/8-6/7/8	662	41	4,090.00
441	5/8	273		
9	107-110	963	100	900.00
126	29-1/2	3717		
400	45-1/4	18100	96-1/4	38,488.75
200	6-3/8	1274	56	11,210.00
500	34-1/2	17250	72	35,994.65
10	210	2100	370-1/2	3,705.00
880	9-3/8	8250	22-1/4	19,520.00
200	4-7/8	974	15-7/8	3,170.00
200	58-3/4	11750	90-1/4	18,040.00
1000	3-1/2	3500	3	3,075.00
306	6-1/2	1989	91	27,835.00
500	18-5/8	9310	121-3/8	60,655.00
100	26	2600	33-3/8	3,340.00
100	21	2100	86	8,595.00
100	2½ - 5	250	61-1/4	6,125.00
300	13-3/8	4011	36-3/4	11,032.50
100	41-1/8	4112	80-1/4	8,020.00
100	12-15 a	1200	37-1/8	3,715.00
		259,391.00		657,514.

HOLDINGS - JANUARY 31, 1930 — NATIONAL GROCERY COMPANY — HOLDINGS - JANUARY 31, 1931

SECURITY - STOCKS	NO. OF SHARES	PRICE 1/[illegible]/30	MARKET VALUE 1/[illegible]/30	UNIT COST	COST	PURCHASES AFTER 1/[illegible]/30			SOLD BEFORE 1/[illegible]/31		NO. OF SHARES	PRICE 1/[illegible]/31	MARKET VALUE 1/[illegible]/31	UNIT COST	COST
INDUSTRIALS CONT'D. Carried Forward			339,+[illegible]		674,[illegible]	74,363 25			54,354 76				254,[illegible]2.00		681,[illegible]6
Residuum Reclamation Corp.	25	b		4	101.00						25	o		4	101.00
Richardson & Garrett Bag Com.	130)	no price available		100	13,000.00						130)	no price available		100	13,000.00
Richardson & Garrett Bag. pfd.	130)	no price available									130)	no price available			
Sears Roebuck Co.	101	85	8989	171-1/4	17,300.00		4 shs S.D.				205	49-7/8	5236	169-3/4	17,300.00
Servel Inc.	300	8-5/8	2586	18-1/8	5,437.50						300	7-1/8	2136	18-1/4	5,437.50
Snider Packing Corp.	500	6-1/2-7	3250	29-1/8	14,545.00						500	2-3/4-3	1375	29-1/8	14,545.00
Standard Oil of Indiana	100	53	5300	55-1/2	5,555.00						100	37-1/4	3725	55-1/2	5,555.00
Standard Oil of N.J.	100	64	6400	73	7,305.00						100	48-1/2	4850	73	7,305.00
Stand.Fruit & S.S.Corp. pfd.	300	35-39 &	10500	59-1/4	17,737.50						300	22 - 25 &	6600	59+1/4	17,737.50
Starrett Corp. 6% pfd.	150	38-1/8	5718	51	7,650.00						150	22+-23+	3375	51	7,650.00
Union Carbide & Carbon Co.	216	85	18360	105-5/8	22,825.00						216	60-1/4	13014	105-5/8	22,825.00
United Biscuit Co.	100	41	4100	49-1/8	4,915.00						100	37-5/8	3762	49-1/8	4,915.00
United Aircraft & Trans.Co.	100	50-3/4	5075	110-3/4	11,075.00						100	27	2700	110-3/4	11,075.00
United States Steel Co.	300	179	53700	168-5/8	50,587.50	16525 00	100 shs		50587 50	300 shs	100	148-3/8	14837	165-1/4	16,525.00
Underwood Elliott Fisher Co.	50	110-5/8	5531	117-3/4	5,287.50				5287 50	50 shs					
Vanadium Corp. of America	300	59-1/2	17850	67	20,092.50				20092 50	300 shs					
Wade & Butcher Corp.6% pfd.	34	no price available		100	3,400.00						34	xx		100	3,400.00
Westinghouse Elec. & Mfg.Co.	300	155	46500	170-3/4	51,230.00	6306 25	50 shs		51230 00	300 shs	50	86-1/8	4306	126-1/8	6,306.25
Wood Newspaper Mchy. pfd.) units	100	91-97 ex	4550	130-3/4	10,075.00						100	bid 55 f	2750	100-3/4	10,075.00
Wood Newspaper Mchy. com.)	50										50				
Woolworth F.W. Co.	300	69-5/8	20886	81-5/8	24,476.25						300	57-3/8	17211	81-5/8	24,476.25
PUBLIC UTILITIES															
American Superpower Corp.	1000	26-1/8	15672	59-3/4	35,880.70						600	11-3/4	7050	59-3/4	35,880.70
American & Foreign Power	100	94-1/4	9425	93-3/8	9,332.50						100	31	3100	93-3/8	9,332.50
American Power & Light Co.						10312 50	12 shs S.D.				112	50-7/8	5697	92	10,312.50
Atlantic City Electric pfd.						10700 00	100 shs				100	102½ -105	10250	107	10,700.00
Brooklyn Union Gas Co.	100	142-1/2	14250	237-3/4	23,780.00						100	109½ -111	10950	237-3/4	23,780.00
Consolidated Gas Co. of N.Y	250	108	27000	135-5/8	33,913.75						250	90	22500	135-5/8	33,913.75
Columbia Gas & Elec. Corp.	10	81-3/8	814	23-5/8	236.40		1/2 sh S.D.		236 40	10 shs	1/2	37	16		
Electric Bond & Share common	256-139/200	85-7/8	22051	126	32,352.00		15-139/200 S.D.				272-97/200	44	11989	118-7/8	32,352.00
Electric Power & Light Co.com.						9032 50	100 shs				100	48	4800	90-3/8	9,032.50
Electric Power & Light 6% pfd.						10050 00	100 shs				100	90-3/4	9075	100-1/2	10,050.00
(f) Engineers Public Service	2-4/100	45-1/2	91							8/100					
General Gas & Elec. 6% pfd.	100	88	8800	100-1/2	10,050.00						100	62	6200	100-1/2	10,050.00
Intercontinents Power A.	4-20/43	19-22 g	85				4/45 S.D.				4-24/45	20-23 h	91		
International Utilities B.	500	8	4000	18-1/4	9,112.50						500	7-1/2	3750	18-1/4	9,112.50
(G) International Tel. & Tel.	200	71	14200	130-3/4	26,150.00	8690 00	125 shs				325	26-3/4	8694	107-1/4	34,840.00
National Power & Light Co.	100	35-1/2	3550	34-5/8	3,465.00				3465 00	100 shs					
Niagara Hudson Power Co.	1100	13-3/4	15125	28-5/8	31,552.50						1100	10-3/4	11825	28-5/8	31,552.50
Public Service Corp. of N.J.	5	87-1/8	435	65	325.00	22725 00	200 shs				205	80	16400	112-1/2	23,050.00
Philadelphia Co. 6% pfd.						9925 00	100 shs				100	98-1/2	9850	99-1/4	9,925.00
Total			734,271.25		1,142,964.01	180,629.60			187,253.66				436,906.00		1,139,639.96

HOLDINGS - JANUARY 31,1930 — NATIONAL GROCERY COMPANY — HOLDINGS - JANUARY 31, 1931

	SECURITY - STOCKS	NO. OF SHARES	PRICE 1/31/30	MARKET VALUE 1/31/30	UNIT COST	COST	PURCHASES AFTER 1/31/30		SOLD BEFORE 1/31/31		NO. OF SHARES	PRICE 1/31/31	MARKET VALUE 1/31/31	UNIT COST	COST
	UTILITIES CONT'D. Forward			734,271.25		1,142,964.01	180,629.50		187,253.66				496,946.00		1,139,686.85
	United Light & Power Co.A.	900	37-1/4	33525	59-3/8	53,382.50					900	25-3/4	23175	59-3/8	53,382.50
	United Gas Corp.						4750	200 shs			200	11-3/8	2275	23-3/4	4,780.00
	United Gas Improvt.Co.						4840	100 shs			100	29-1/2	2950	43-3/8	4,340.00
	RAILROADS														
•	Canadian Pacific R.R.Co.	50	199-1/2	9975	167	8,352.50									
	Cinn. N. O. & Texas Pacific R.R.Co.	30 bid	325 i	9750	458-3/4	13,761.00			8352 50	50 shs					
(H)	Chesapeake & Ohio R.R.Co.						649				30	240-290 j	7200	458-3/4	13,761.00
•	Georgia South & Florida R.R.Co.	10	50 - 75 k	500	120-1/4	1,202.50					114	43-3/4	4986	30-1/2	3,482.50
(I	Hocking Valley R.R.Co.	10	450	4500	283-3/8	2,833.50					10 off	15 s	150	120-1/4	1,202.50
•	Virginia Railway	100 off.	150 m	15000	185-1/2	18,550.00									
											100	110-115 u	11000	185-1/2	18,550.00
	INSURANCE														
	Aetna Life Ins.Co.	100	89-93	8900	146	14,600.00									
(J)	Aetna Fire Ins.Co.	25	580-595	14500	832	20,800.00					100	61-63	6100	146	14,600.00
	American Ins.Co.	200	20½-21	4100	24-7/8	4,975.00					250	51-53	12750	83-1/4	20,800.00
	American Reserve Ins.Co.	50	63-64	3000	91-1/2	4,575.00					200	18-19	3600	24-7/8	4,975.00
	Baltimore Amer.Ins.Co.	400	26½-27	10600	39-7/8	15,950.00		13-2/3 shs S.D.			66-2/3	29½-33	1967	68-3/4	4,575.00
	Equitable Cas. & Surety Co.	130	50 - 60 o	6500	55-3/8	7,200.00	325	65 shs			400	10½-11½	4200	39-7/8	15,950.00
	Eagle Fire Ins.Co.						1375	100 shs			195	2½-4 p	487	38-1/2	7,525.00
	Firemen's Ins.Co.	665	33½-34	22111	45-5/8	30,330.13	7300	200 shs			100	13-13⅜	1300	13-3/4	1,375.00
	Fire Association of Philadelphia	50	36-38 q	1800	52-1/2	2,625.00					865	29½-30½	25517	43-1/2	37,630.13
											50	19-21 r	950	52-1/2	2,625.00
	Great American Ins.Co.	393	33-35	12969	47-1/2	18,647.50									
	Home Ins.Co.	270	45-47	12150	53	14,307.00	4375	100 shs			393	27½-28½	10807	47-1/2	18,647.50
	Hanover Fire Ins.Co.	100	53-55	5300	91	9,100.00					370	35⅝-36⅝	13227	50-1/2	18,682.00
	Home Fire Security Corp.	400	22-24	8800	34-1/2	13,800.00					100	32-36	3200	91	9,100.00
	Insurance Securities Co.	500	18½-19½	9250	27-7/8	13,930.00					400	6½-7½	2600	34-1/2	13,800.00
	National Liberty Ins.Co.	400	18-18½	7200	31-1/8	12,455.00					500	7-7/8	3935	27-7/8	13,930.00
	Peoples Natl.Fire. Ins.Co.	500	18⅝-19	9375	38	19,038.75					400	8-7/8-9-1/8	3248	31-1/8	12,455.00
	Stuyvesant Ins.Co.	240	60-67	14400	120	28,800.00					500	5½ - 6½	2750	38	19,038.75
	Virginia Fire & Marine Ins.Co.	50	100-115	5000	145	7,250.00					240	35-40	8400	120	28,800.00
											50	80-90	4000	145	7,250.00
	INVESTMENT TRUSTS														
•	Alleghany Corp. 5½% pfd.	70	99	6930	100	7,000.00									
•	Atlantic & Pacific Int.Corp. pfd.	100	25-35 rx	2500	73	7,300.00					70	53-57	3710	100	7,000.00
•	Atlantic & Pacific Int. Corp. com.	102-41/80	13 - 14 t	1333							100 bid	12-1/4 s	1225	73	7,300.00
	American International Corp.	2	39-3/4	79							102-41/80 bid	1-3/4 u	179		
	Blue Ridge Corp. pfd.	100	37-7/8	3787	38-7/8	3,890.00					2	20-5/8	41		
	Electric Shareholdings Corp.	5-3/10	19-5/8	98				3/20 S.D.			100	31-3/4	3175	38-7/8	3,890.00
	Electric Power Associates	100	26-1/8	2612	31-3/8	3,140.00					5-9/20	10-3/8-10-7/8	56		
	General Realty & Utility 6% pfd.	100	80 - 84	8000	99	9,898.00					100	16	1600	31-3/8	3,140.00
	General Realty & Utility Common	15	14 - 1/4	214							100	59-61	5900	99	9,898.00
(K)	Haygart Corp.	70	37-42-1/4	2590	47-1/8	3,300.00		7 shs S.D.			22	6-1/4	138		
	TOTAL			991,620.25		1,513,957.39	203,743.50		195,606.16				663,704.00		1,522,094.73

HOLDINGS - JANUARY 31,1930 | NATIONAL GROCERY COMPANY | HOLDINGS - JANUARY 31,1931

	SECURITY - STOCKS	NO. OF SHARES	PRICE 1/31/30	MARKET VALUE 1/31/30	UNIT COST	COST	PURCHASES AFTER 1/31/30		SOLD BEFORE 1/31/31		NO. OF SHARES	PRICE 1/31/31	MARKET VALUE 1/31/31	UNIT COST	COST
	INVESTMENT TRUSTS CONT'D. Forwarded-			991.62a.25		1.513.957.39	203.74150		195.60.46				662.704.00		1.522.096.78
*	Insuranshares common	25	bid 23 v	$575							25	bid 1 x	25		
*	Insuranshares pfd.	50	off 55 w	2750	150	7,500.00					50	28-3/4 y	1400	150	7,500.00
	Investment Fund of N.J.	200	7-5/8-3/4	1524	8	1,600.00					200	7-3/8-3/4	1474	8	1,600.00
	New York Investors Corp.	100	22-7/8	2287	49	4,900.00					100	11-5/8	1162	49	4,900.00
(L)	Stone & Webster										1	45-1/2	45		
	Chatham & Phenix Allied Corp.	200	19-7/8	3975	18-1/2	3,700.00					200	15-1/2	3100	18-1/2	3,700.00
	BANKS														
(M)	Beacon Trust Co.	15	50	3750	60	4,500.00			50.00	1/2 sh					
(N)	Atlantic Natl.Bank & Tr.Co.										37	71-1/2	2645 50	120	4,450.00
(O)	American Express Bk. & Tr.						8000	50 shs			50	217-1/2	10875	160	8,000.00
	Bank of America	70	132	9240	230-5/8	16,141.50					70	64	4480	230-5/8	16,141.50
	Bank of United States	340	74	25160	202-5/8	68,907.50					340	2	680	202-5/8	68,907.50
	Central Hanover Bk. & Tr.	50	319-1/2	15975	460	23,000.00					50	251-1/2	12575	460	23,000.00
(P)	Chase National Bank						10.56	8/100 shs			242	100-1/2	24321	182-5/8	44,200.31
(P)	Equitable Trust Co.	260	108	28080	171-1/8	34,235.75			7647.00	60 shs					
(P)	Interstate Trust Co.	256	33	8448	68-3/4	17,601.00									
	Commercial Trust Co. of N.J.	5860	185	1083280	66	386,340.00			3482.50	30 shs	5820	132	768240	65-3/4	382,857.50
	First Natl.Jersey City	472	99-5/8	44840	106-1/2	50,300.50	23400	300 shs			772	50	38600	95-1/2	73,700.50
	Hudson County Natl.Bank	1738	140	243320	78	135,582.19			20900 00	200 shs	1538	83	127654	74-1/2	114,682.19
	Chatham & Phenix Bk. & Tr.	25	123	3075	118	2,950.00					25	79-1/2	1987 50	118	2,950.00
	Com'l.Natl.Bank & Tr.	10	495	4950	82	8,209.00					10	310	3100	82	8,209.00
	Continental Bank & Tr.	100	40	4000	60-1/4	6,025.00					100	23	2300	60-1/4	6,025.00
	Federal Trust Co.	75	119	8925	160-3/8	12,025.00					75	100-1/2	7537 50	160-3/8	12,025.00
	First Natl.Bank Hoboken	128	205	26240	208-1/2	26,687.00					128	120	15360	208-1/2	26,687.00
	Irving Trust Company	400	52-1/2	21000	69-1/2	27,780.00					400	37-3/8	14950	69-1/2	27,780.00
	Manufacturers Trust Co.	95	130	12350	286-1/2	27,211.27					95	45-1/2	4322 50	286-1/2	27,211.27
	Morristown Trust Co.	20	125	2500	154	3,080.00					20	120	2400	154	3,080.00
	N.J.Title Guar. & Tr.Co.	628	165	103620	183	114,909.87					628	96	60288	183	114,909.87
	Seward Natl.Bank	50	122-1/2	6125	227-1/2	11,373.50					50	73-1/2	3675	227-1/2	11,373.50
	Trust Co. of N.J.	680	145	98600	178-1/8	121,126.60					680	86	58480	178-1/8	121,126.60
	State Planters Bank & Tr.	100	48	4800	70	7,000.00					100	39-3/8	3937 50	70	7,000.00
	Bergen Trust Co.	100	no price available		175	17,500.00					100	no price available		175	17,500.00
	Atlanta Trust Co.	50	no price available		160	8,000.00					50	no price available		160	8,000.00
	Nat'l.Com'l.Title & Mtge.	200	17-1/2	3500	32-1/4	6,450.00					200	16	3200	32-1/4	6,450.00
	United States Trust Co.	5	3200	16000	2550	12,750.00			12750 00	5 shs					
				2,779,479.25		2,661,343.07	235,154.06		24.435.66				1.942.518.50		1.676.061.47

HOLDINGS - JANUARY 31, 1930 | NATIONAL GROCERY COMPANY | HOLDINGS - JANUARY 31, 1931

SECURITY - BONDS	NO. OF BONDS	PRICE 1/[illegible]/30	MARKET VALUE 1/[illegible]/30	UNIT COST	COST	PURCHASES AFTER 1/[illegible]/30		SOLD BEFORE 1/[illegible]/31	NO. OF BONDS	PRICE 1/[illegible]/31	MARKET VALUE 1/[illegible]/31	UNIT COST	COST
INDUSTRIALS Caramba Feature			3,779,479.25		1,691,343.07	235,184.06		240,435.66			1,942,518.50		2,676,061.47
Abraham & Strauss Deb.5½-1943	5M	98-1/2-99-3/8	4925	101	5,050.00				5M	94-1/2-96	4725	101	5,050.00
American International Corp. conv.deb.5½-1949	9M	93-1/2	8415	105	9,450.00				9M	93	8370	105	9,450.00
Cities Service Co.5-1950						24937 50	25M		25M	77-3/4	19437	99-3/4	24,937.50
Empire Oil & Ref. 5½-1942						8867 50	10M		10M	78-1/4	7825	88-5/8	8,867.50
General Amer.Investors 5-1952	10M	82	8200	96-5/8	9,660.00				10M	88	8800	96-5/8	9,660.00
Gen'l.Motors Accept. 6-1937						10325 00	10M		10M	103-1/2	10350	103-1/4	10,325.00
National Dairy Prod.5½-1948						9750 00	10M		10M	100-7/8	10087	97-1/2	9,750.00
Pure Oil Co. S.F.5½-1940						9350 00	10M		10M	91	9100	98-1/2	9,450.00
MISCELLANEOUS													
Jersey City Chamber of Commerce Ref.Mtge.5-1975	10M	no price available		100	10,000.00				10M	no price available		100	10,000.00
Roman Catholic Church German Welfare 7-1946	10M	80-83 ad	8000	98-3/4	9,875.00				10M	70-71 bb	7000	98-3/4	9,875.00
PUBLIC UTILITIES													
American Tel. & Tel.Conv.Deb. 4½-1939	20M	141-1/4	28250	145	28,990.00			28990 00 20M					
Associated Gas & Elec. 5-1950						8750 00	10M		10M	76-1/2	7650	87-1/2	8,750.00
Central States Electric 5½-1954	10M	74-1/2	7450	99-1/2	9,950.00				10M	68-1/2	6850	99-1/2	9,950.00
Continental Gas & Elec. 5-1958						8875 00	10M		10M	83-1/4	8325	88-3/4	8,875.00
Intercontinents Power Deb. 6-1948	10M	87-90	8700	96	9,600.00				10M	bid 54 oc	5400	96	9,600.00
Illinois Power & Lt. Corp.6-1953						10400 00	10M		10M	102½-103½ x	y10250	104	10,400.00
Laclede Gas Light 5½-1960						10300 00	10M		10M	103-1/4	10325	103	10,300.00
Middle West Utilities 5-1932						4993 75	5M		5M	99-7/8	4993	98-7/8	4,993.75
Middle West Utilities 5-1933						4942 25	5M		5M	99-1/4	4862	98-7/8	4,942.25
RAILROADS													
Bluff Point Land Impvt.1st mtg.4-40	1M	85-87 dd	850	80	800.00				1M	bid 87-1/2 ee	875	80	800.00
Louisiana & Ark.Rwy. 5-1969						8675 00	10M		10M	69-1/2	6950	86-3/4	8,675.00
MUNICIPALS													
City of New York 4-1/4-1962						25906 25	25M		25M	103-5/8	25906	103-5/8	25,906.25
City of East Orange 4-1/2-1947						26001 99	25M		25M	102½-104½	25625	104	26,001.99
City of Detroit 4-1/2-1960						25990 34	25M		25M	106-107	26500	104	25,990.34
Boro of Glen Ridge 4-1/4-1965						6102 00	6M		6M	107-109	6420	101-3/4	6,102.00
Boro of Glen Ridge 4-1/4-1966						4069 15	4M		4M	107-109	4280	101-3/4	4,069.15
Town of Montclair 4-1/4-1940						10107 33	10M		10M	off 104	10400	101	10,107.33
City of Paterson 4-1/4-1955						25163 81	25M		25M	off 106	26500	100-5/8	25,163.81
GOVERNMENT													
U.S.First Liberty 3½-32-47	5M	98.31	4948	100	5,000.00				5M	102.7	5111	100	5,000.00
GRAND TOTAL			2,859,217.25		2,779,799.07	479,160.33		269,435.66			2,125,434.50		2,999,452.74

Exhibit 16.

Photo of 1st Warehouse.

(*Opposite* ☞)

NATIONAL GROCERY COMPANY
MAZON
COFFEE
NATIONAL
GROCERY COMPANY
WONDER
BREAD
FOR HUMAN NEEDS
Give

Exhibit 17.

Photo of Bakery and Stable.

(*Opposite* ☞)

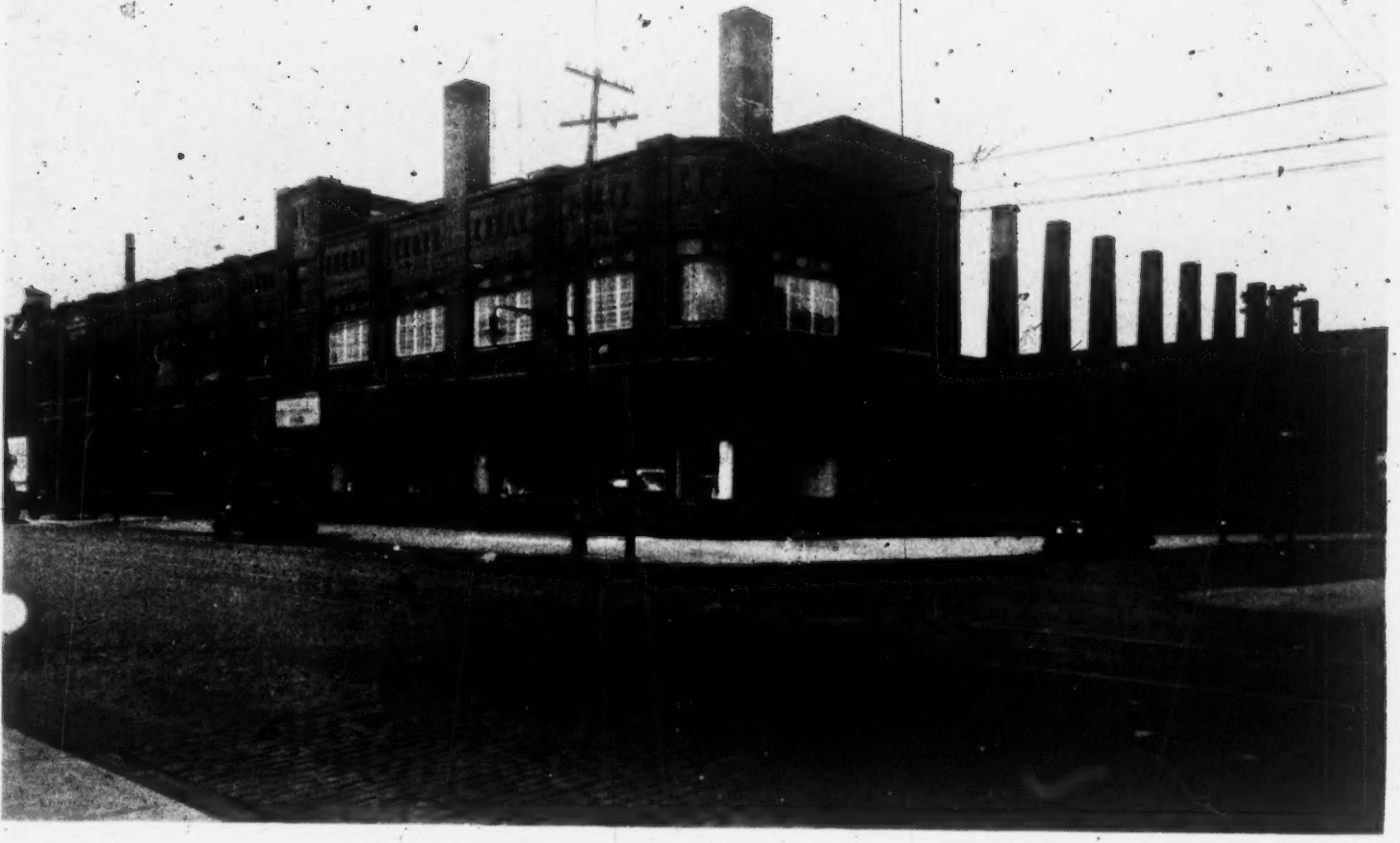


Exhibit 18.

Photo of Office Bldg., Warehouse and Garage.

(*Opposite* ☞)

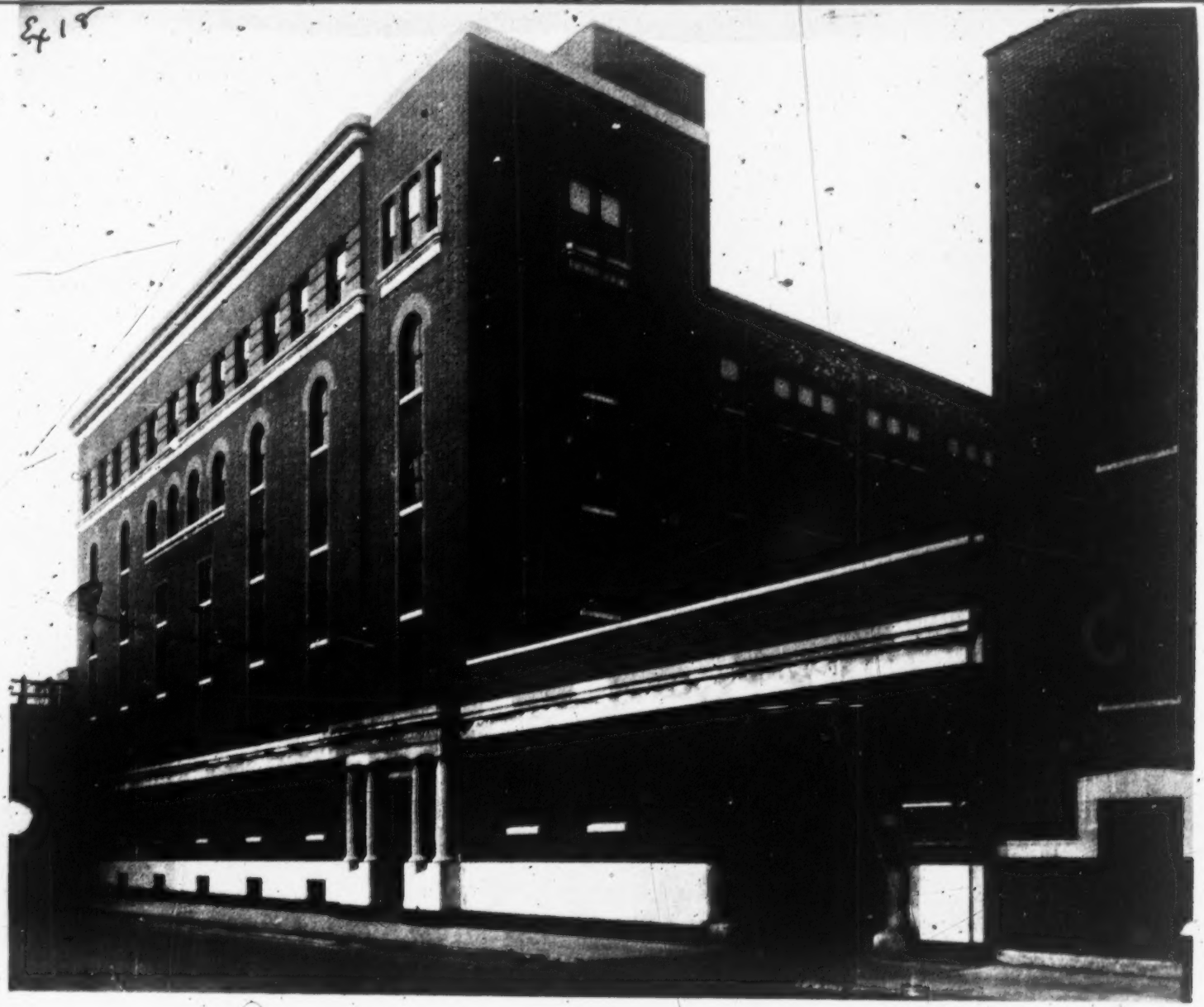


Exhibit 19.

Checks (4) Front and Back.

(*Opposite* ☞)

No. 5964 JERSEY CITY, N.J. Dec 1st 1930

HENRY KOHL

PAY TO THE ORDER OF Young Women's Christian Assn. $500.00/100
Maintenance Fund
EXACTLY $500 & 00 CTS.

To HUDSON COUNTY NATIONAL BANK
55-32 JERSEY CITY, N.J. 55-32

HENRY KOHL
Henry Kohl

No. 5842 JERSEY CITY, N.J. Sept 2nd 1930

HENRY KOHL

PAY TO THE ORDER OF Young Women's Christian Assn. $500.00/100
Maintenance Fund
EXACTLY $500 & 00 CTS.

To HUDSON COUNTY NATIONAL BANK
55-32 JERSEY CITY, N.J. 55-32

HENRY KOHL
Henry Kohl

No. 5688 JERSEY CITY, N.J. May 22nd 1930

HENRY KOHL

PAY TO THE ORDER OF Young Women's Christian Assn. $500.00/100
Maintenance Fund
EXACTLY $500 & 00 CTS.

To HUDSON COUNTY NATIONAL BANK
55-32 JERSEY CITY, N.J. 55-32

HENRY KOHL
Henry Kohl

No. 5617 JERSEY CITY, N.J. April 1st 1930

HENRY KOHL

PAY TO THE ORDER OF Young Women's Christian Assn. $938.20/100
Maintenance Fund
PER SCHED $938.20 AND 35 CTS

To HUDSON COUNTY NATIONAL BANK
55-32 JERSEY CITY, N.J. 55-32

HENRY KOHL
Henry Kohl

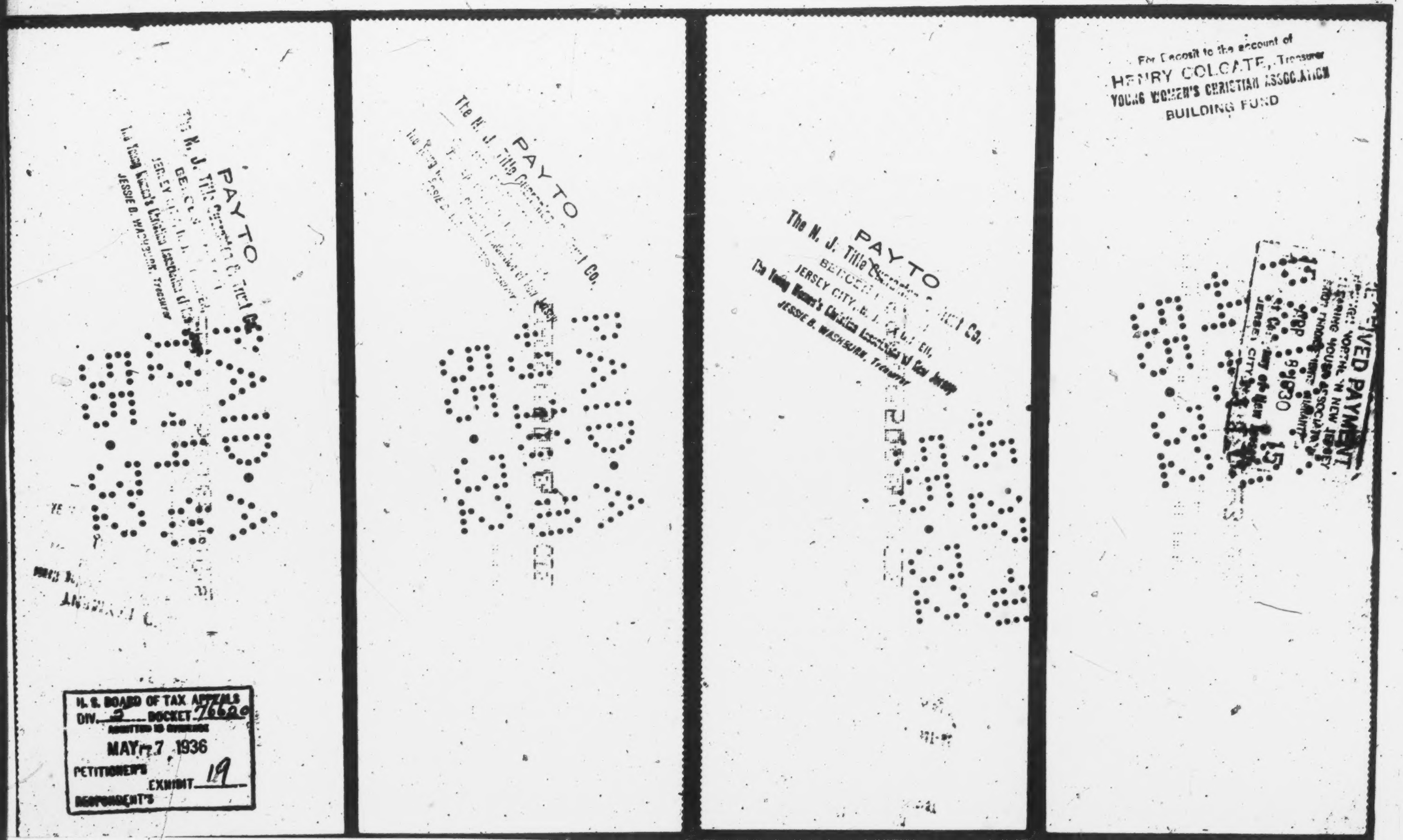

PAY TO
The N. J. Title Guarantee & Mtge. Co.
JESSIE B. WASHBURN, Treasurer
PAY TO
The N. J. Title Guarantee & Mtge. Co.
PAY TO
The N. J. Title Guarantee & Mtge. Co.
JERSEY CITY, N. J.
JESSIE B. WASHBURN, Treasurer
For Deposit to the account of
HENRY COLGATE, Treasurer
YOUNG WOMEN'S CHRISTIAN ASSOCIATION
BUILDING FUND
RECEIVED PAYMENT
JERSEY CITY
MAR 6 1930
U. S. BOARD OF TAX APPEALS
DIV. 5 DOCKET 76620
ADMITTED IN EVIDENCE
MAY 7 1936
PETITIONER'S
EXHIBIT 19
RESPONDENT'S

Exhibit 20.

Checks (2) Front and Back.

(*Opposite* ☞)

No. 5527 JERSEY CITY, N.J. Feb. 15th 1930

HENRY KOHL

PAY TO THE ORDER OF J. L. C. A. (Maintenance Fund 1929) $500.00/100

EXACTLY 500 & 00 CTS.

To HUDSON COUNTY NATIONAL BANK
55-32 JERSEY CITY, N.J. 55-32

HENRY KOHL
Anna L. Mullins

FEB 24 1930
ANDREW C. GREENE

PAY TO
THE N. J. Title Guarantee & Trust Co.
BERGEN BRANCH
JERSEY CITY, N. J. OR ORDER
JENNIE E. RICHARDSON, Treasurer

No. 6044 JERSEY CITY, N.J. Jan. 1st 1931.

HENRY KOHL

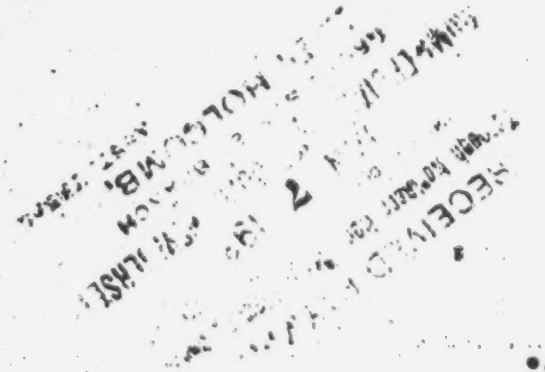
PAY TO THE ORDER OF Commercial Trust Co. Prov. Ft. Rh. $100000.00/100

EXACTLY $100000 & 00 CTS.

To HUDSON COUNTY NATIONAL BANK
55-32 JERSEY CITY, N.J. 55-

HENRY KOHL

Henry Kohl



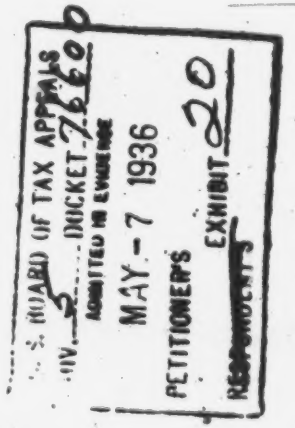


Exhibit 21.

14 Notes.

(*Opposite* ☞)

$25,000 00/100 May 3, 1926

On demand after date I promise to pay to

the order of NATIONAL GROCERY COMPANY

THE SUM OF $25000 AND 00 CTS Dollars

at Jersey City

Value received

1020 Due

Henry Kohl

$65,000 00/100

JERSEY CITY, N.J. DECEMBER 28TH 1932

ONE MONTH- after date I promise to pay to

the order of MYSELF

EXACTLY $65000 & 50 CTS. Dollars.

Payable at HUDSON COUNTY NATIONAL BANK
At Montgomery & Washington Sts.
INTEREST @ 4% JERSEY CITY, N. J.

Value received.

No. 3093 Due

Henry Hohl

$65,000 00/100

JERSEY CITY, N.J. NOVEMBER 28TH 1932

ONE MONTH after date I promise to pay to

the order of MYSELF

EXACTLY $65000 & 00 CTS. Dollars.

Payable at HUDSON COUNTY NATIONAL BANK
At Montgomery & Washington Sts.
INTEREST @ 4% JERSEY CITY, N. J.

Value received.

No. 3023 Due 12-28-32

CANCELLED

Henry Hohl

$65,000 00/100

JERSEY CITY, N.J. OCTOBER 26TH 1932

ONE MONTH after date I promise to pay to

the order of MYSELF

EXACTLY $65000 & 00 CTS. Dollars.

Payable at HUDSON COUNTY NATIONAL BANK
At Montgomery & Washington Sts.
INTEREST @ 4% JERSEY CITY, N. J.

Value received.

No. 2[illegible] Due

Henry Hohl 11/28/32

$65,000 00/100

JERSEY CITY, N.J. SEPTEMBER 26TH 1932

ONE MONTH after date I promise to pay to

the order of MYSELF

EXACTLY $65000 & 00 CTS. Dollars.

Payable at [illegible] NATIONAL
WITH INTEREST AT 4% At [illegible]
[illegible] JERSEY CITY, N. J.

Value received.

No. 2607 Due

Henry Hohl

CANCELLED

Henry Kohl

Henry Kohl

Henry Kohl

Henry Kohl

$30,000 00/100

JERSEY CITY, N.J. APRIL 21ST 1930

ON DEMAND after date I promise to pay to

the order of NATIONAL GROCERY COMPANY

EXACTLY $30000 & 00 CTS. Dollars.

Payable at COMMERCIAL TRUST CO., GROVE ST. BRANCH, JERSEY CITY, N. J.

Value received.

No. Due

J.W. Harrison, 9 Exchange Place, Jersey City, N.J.

$25,000 00/100

JERSEY CITY, N.J. MARCH 10TH 1932

ON DEMAND after date I promise to pay to

the order of NATIONAL GROCERY COMPANY

EXACTLY $25000 & 00 CTS. Dollars.

Payable at 300 MERCER ST., JERSEY CITY, N. J.

Value received.

No. Due

J.W. Harrison, 9 Exchange Place, Jersey City, N.J.

$10,000 00/100

JERSEY CITY, N.J. DECEMBER 17TH 1929

ON DEMAND after date I promise to pay to

the order of NATIONAL GROCERY COMPANY

EXACTLY $10000 & 00 CTS. Dollars

Payable at JERSEY CITY, N. J.

Value received.

No. Due

J.W. Harrison 9 Exchange Place Jersey City N.J.

$10,000 00/100

JERSEY CITY, N.J. JUNE 16TH 1930

ON DEMAND after date I promise to pay to

the order of NATIONAL GROCERY COMPANY

EXACTLY $10000 & 00 CTS. Dollars

Payable at 300 MERCER ST., JERSEY CITY, N.J.

Value received.

No. Due

J.W. Harrison 9 Exchange Place Jersey City N.J.

$40,000 00/100

JERSEY CITY, N.J. MARCH 17TH 1931

ON DEMAND after date I promise to pay to

the order of NATIONAL GROCERY COMPANY

EXACTLY $40000 & 00 CTS. Dollars

Payable at JERSEY CITY, N. J.

Value received.

No. Due

J.W. Harrison 9 Exchange Place Jersey City N.J.

$100,000 00/100

JERSEY CITY, N.J. JANUARY 9TH 1931

ON DEMAND after date I promise to pay to

the order of NATIONAL GROCERY COMPANY

EXACTLY $100000 & 00 CTS. Dollars

Payable at JERSEY CITY, N. J.

Value received.

No. Due

J.W. Harrison 9 Exchange Place Jersey City N.J.

Paid 60,000.00 on account of the note

Drew note for balance

$10,000 00/100

JERSEY CITY, N.J. January 22nd 1929.

On Demand after date I promise to pay to

the order of NATIONAL GROCERY COMPANY

THE SUM OF $10000 AND 00 CTS Dollars.

Payable at Jersey City, N. J.

Value received.

No. Due

J.W. Harrison 9 Exchange Place Jersey City N.J.

$10,000 00/100

JERSEY CITY, N.J. December 28 1928.

On demand after date I promise to pay to

the order of NATIONAL GROCERY COMPANY

THE SUM OF $10000 AND 00 CTS Dollars.

Payable at Commercial Trust Co. Grove Street Branch, Jersey City, N.J.

Value received.

No. Due

J.W. Harrison 9 Exchange Place Jersey City N.J.

$15,900.00

JERSEY CITY, N.J. JULY 3RD 1928 192

ON DEMAND after date I promise to pay to

the order of NATIONAL GROCERY COMPANY

THE SUM OF $15900 AND 00 CTS Dollars.

Payable at JERSEY CITY, N.J.

Value received.

No. Due

Exhibit 22.

2 Notes.

(*Opposite* ☞)

No. 7018 JERSEY CITY, N.J. Sept 26th 1912.

HENRY KOHL

PAY TO THE ORDER OF Hudson Co. National Bank $65000.00/100

EXACTLY $65000 & 00 CTS.

To HUDSON COUNTY NATIONAL BANK HENRY KOHL

33-32 JERSEY CITY, N.J. 33-32

Henry Kohl

No. 6983 JERSEY CITY, N.J. Aug 25th 1912.

HENRY KOHL

PAY TO THE ORDER OF National Grocery Company $65000.00/100

EXACTLY $65000 & 00 CTS.

To HUDSON COUNTY NATIONAL BANK HENRY KOHL

33-32 JERSEY CITY, N.J. 33-32

Henry Kohl

U.S. BOARD OF TAX APPEALS
DIV. 5 DOCKET 76600
ADMITTED IN EVIDENCE
MAY - 7 1936
PETITIONER'S
EXHIBIT 221
RESPONDENT'S

Pay COMMERCIAL TRUST COMPANY
OF NEW JERSEY (GROVE STREET)
Jersey City, N. J.
NATIONAL GROCERY CO.

RECEIVED PAYMENT
through Northern New Jersey Clearing House
PRIOR ENDORSEMENTS GUARANTEED
AUG 25 1930
COMMERCIAL TRUST CO. OF NEW JERSEY
GROVE STREET BRANCH
R. D. HOLCOMB,
ASST. TREAS.

Exhibit 23.

1 Sheet.

Showing Monthly Bank Stock Prices 1930, etc.

(*Opposite* ☞)

HIGH AND LOW PRICES FOR 1930

	JAN H	JAN L	FEB H	FEB L	MAR H	MAR L	APR H	APR L	MAY H	MAY L	JUNE H	JUNE L	JULY H	JULY L	AUG H	AUG L	SEPT H	SEPT L	OCT H	OCT L	NOV H	NOV L	DEC H	DEC L
BANK OF AMER	136	125	134	126	141½	125½	149	138	140	129	130	92	100	95	95	86	104	84	90	74½	75½	65	65	53
BANK OF US UNITS	74	64¾	91	66	84½	77	79	70	70	61	60½	39	43½	40¾	40½	37½	42½	35	36	30	31	13	18½	8
CHASE NAT'L	168	154	171	160	178	159	170	163	169	156	168	120	141½	128	145	132½	150½	129½	133	110	111	97½	101	75½
CHATHAM	123	113	126	124½	140	126	140	134	141	128	138½	98	107	100	107	105	112	99	101	88	88	80	80	69
COMM'L NAT'L	514	465	575	510	600	565	570	523	538	500	540	385	420	360	410	365	435	380	390	280	290	265	294	245
SEWARD NAT'L	124	106	121	114	142	105	138	122	125	108	112	87	92	81	83	82	83	80	85	76	76	68	70	55
AMER EXPRESS	. . . . .		. . . . .		. . . . .		. . . . .		200	170	190	170	220	175	220	. . .	240	220	230	200	215	200	210	175
CENTRAL HAN	321	310	362	318	405	344	405	387	396	373	389	316	365	325	342	316	360	317	322	260	270	236	245	200
CONTINENTAL	42	36	38	30	45½	38	44	37	38	34	36	25	28½	25	29½	25½	29½	23½	24	19	20½	17	17½	13½
IRVING TRUST	56	52½	59	54	74	56	69	62	63	56	59½	45	52½	46½	51½	47½	53½	43½	46½	39	39½	32	37	29½
MANUFACTURERS	140	129	150	129	152	145	148	139	138	126	129½	89	100	93	93½	80	92	78½	80½	64½	68½	49½	49	25
COM'L TRUST NJ							170	168	170	165	155	155	150	148	145	145	. . . . .		140	132	138	136	136	136
N J TITLE							140	140	140	137	136	132	125	123	120	120	. . . . .		115	100	102	100	101 1/2	96 7/8
TRUST CO N J							135	130	125	125	105	105	120	120	. . . . .		107	103	104	103	100	100	87	87
HUDSON CO NAT'L							140	130	125	115	100	90	120	120	. . . . .		110	110	. . . . .		90	90	90	88
FIRST OF J C							100	90	100	90	100	90	100	90	90	75	90	90	90	90	90	90	50	50
FIRST OF HOB	205	205	165	165	180	170	165	170	180	170	165	155	175	160	165	135	155	135	155	135	155	135	140	120
ATLANTIC NAT'L	100	95	98	95	101	101	105	102	100	99	92	90	95	93	95	93	95	93	92	90	89	87	73	70
STATE PLANTERS BANK & TRUST	49	47	50	48½	47	46	46½	45½	45	44	43½	43	44	43½	46	43½	43½	42½	42	40½	41	40	39½	40½
FEDERAL TRUST	121	117	120	115	120	117	125	123	120	117	112	109	112	109	113	109	112	108	105	100	105	100	101	98
MORRISTOWN TR	125	125	125	125	125	125	125	125	125	125	125	125	125	125	125	125	120	120	120	120	120	120	120	120
NAT'L COM'L TITLE & MTGE	17½	17½	17½	17½	. . . . .		. . . . .		. . . . .		. . . . .		. . . . .		18 3/8	18½	. . . . .		. . . . .		. . . . .		16	16

YEARLY HIGH AND LOW PRICES

	1929 H	1929 L	1930 H	1930 L	1931 H	1931 L	1932 H	1932 L	1933 H	1933 L	1934 H	1934 L
AMER EXPRESS	. . . . .		240	170	195	140	. . . . .		. . . . .		. . . . .	
BANK OF AMER	240	131	182	53	71	28	. . . . .		. . . . .		. . . . .	
CENTRAL HAN	475	314	405	200	277	112	162	78	150½	98½	135	100
CHASE NAT'L	*1115 248	918 164	178	79¾	108½	35	48	19	37¾	15¾	71	19½
CHATHAM	*265 198	275 115	141	69	85	15½	21½	17¾	. . . . .		. . . . .	
COM'L NAT'L	905	480	600	245	330	130	188	83	155	99	157	118
CONTINENTAL	*870 93	575 34	45½	13¾	21¾	13	21¾	10¾	19	9	14¾	10¾
IRVING TRUST	*810 90	525 54	74	29¾	43	15	29	11	20	11	19¾	13
MANUFACTURERS	306	135	152	25	54	27½	36¾	15	31½	10½	23½	14¾
SEWARD NAT'L	185	90	142	55	90	58	. . . . .		. . . . .		. . . . .	
BANK OF US UNITS	224	222	91	3/4	3¾	3/4	. . . . .		. . . . .		. . . . .	
COM'L TR N J	220	183	170	132	137	79	87	55	71	28½	48	27½
N J TITLE	201	165	140	96	96	73	68	34	29	9	11¾	6
TRUST CO N J	194	140	135	87	89	45½	51	32½	32	8¾	7	4
HUDSON CO NAT'L	172	132	140	90	85	45	42	25	20½	14	16½	8
FIRST OF J C	110	90	90	50	68	48	25	20	16½	10½	20	14
FIRST OF HOB	205	170	205	120	140	68	60	30	7½	3	5½	2½
ATLANTA TRUST	105	101	. . . . .		. . . . .		. . . . .		. . . . .		. . . . .	
ATLANTIC NAT'L	400	90	105	70	70	28	16½	1/8	. . . . .		. . . . .	
STATE PLANTERS BANK & TRUST	57	45	50	40	40½	24	25	19	18	14½	15	11
FEDERAL TRUST	155	116	122	98	99	63	53	35	40	27	23	14
MORRISTOWN TR	*450 150	400 125	130	120	. . . . .		65	65	29	28	22	22
NAT'L COM'L TITLE & MTGE	25	21	17½	16	16	10	7½	5	2¼	1	1½	1

H & L PRICES JAN. 1931

	H	L
AMER EXPRESS	225	190
BANK OF AMER	66½	62½
CENTRAL HAN	254	249
CHASE NAT'L	102	99
CHATHAM	81	78
COM'L NAT'L	315	305
CONTINENTAL	24½	21½
IRVING TRUST	38 3/8	38 3/8
MANUFACTURERS	48½	44½
SEWARD NAT'L	76	71
BANK OF US UNITS	3¢	3/4
COM'L TR N J	136½	132
N J TITLE	96	95
TRUST CO N J	89	83
HUDSON CO NAT'L	83	83
FIRST OF J C	80	50
FIRST OF HOB	140	120
ATLANTA TRUST	. . . . .	
ATLANTIC NAT'L	73	70
STATE PLANTERS BANK & TRUST	39¢	39
FEDERAL TRUST	102	99
MORRISTOWN TR	120	120
NAT'L COM'L TITLE & MTGE	16	1

* CHASE NAT'L — In May 1929 par value changed from $100 to $20 - 5 shares for one
* CHATHAM & PHEN.IX — In Sep 1929 par valu changed from $100 to $20 - 5 shares for one
* CONTINENTAL BK & TR — In May 1929 par value changed from $100 to $10 - 10 shares for one
* IRVING TRUST CO. — In Aug 1929 par value changed from $100 to $10 - 10 shares for one
* MORRISTOWN TRUST — In May 1932 par value changed from $100 to $25 - 4 shares for one

Exhibit 24.

Large Map.

(*Opposite* ☞)

Penna. R. R.

Waldo Ave. Yard

ACADEMY ST

RAILROAD AVE.

PRIOR ST.

ST.

WAYNE ST.

MERCER ST.

MONTGOMERY ST.

FREMONT ST.

MERSELES ST.

N. J. Junction R.R. Branch

National Docks & (L.V.R.R.)

Passage way

Vacant

1-Brick

Br.

1-Fp

2124
838

Pintch Compressing Co

3 Fireproof Re. Concrete

Mongol Fireproof Re. Concrete

Fan Room

Boiler Room Brick

General Baking Co

Brick

Manhattan Laundry

2123
837

Brick on Floors

General Baking Co

Boiler Room

6

6 & Bas. Fireproof Brick & Re. Concrete

1 Fireproof Brick & Re. Concrete

NATIONAL GROCERY CO.

433
912

3 Fireproof Re. Concrete

Joseph Dixon Crucible Co.

2 & Bas. Brick

2123½
493

John F. Boyle & Co.

1-Frame Iron Clad

2-Frame

1-Frame

Boiler Room

1-Frame Iron Clad

1-Frame

4 & Bas. Fireproof Brick & Concrete

5

NATIONAL GROCERY CO.

1 Frame

2128
836

Central Storage & Realty Co

3 Brick

4

2

1

1 & Bas. Brick

18 Bas. Brick

NATIONAL GROCERY CO.

3

2 Fireproof Brick & Concrete

2 & Bas. Brick

1 & Bas. Brick

2 & Bas. Brick

Prepared By
THE PERCY A. GADDIS, CO.
900 BERGEN AVE.
JERSEY CITY, N.J.

April 4, 1920 W.C.S.

2128 City Block
836 County Block

Exhibit "A"

5/6/36

NATIONAL GROCERY COMPANY

SECURITIES

Year	Yr. Ending	Cost	Market
1927	1/31/28	$2,425,802.38	$3,499,094.33
1928	1/31/29	2,414,894.43	3,353,956.88
1931	1/31/32	4,110,069.64	2,235,071.57
1932	1/31/33	4,804,170.06	2,912,719.45
1933	1/31/34	5,100,889.58	3,095,968.73
1934	1/31/35	5,271,145.29	3,397,310.03
1935	1/31/36	5,575,837.26	4,323,763.75
1929	1/31/30	previously submitted.	
1930	1/31/31		

Praecipe.

UNITED STATES BOARD OF TAX APPEALS

NATIONAL GROCERY COMPANY, body corporate, Petitioner, *vs.* COMMISSIONER OF INTERNAL REVENUE, Respondent.	Docket No. 76600. Praecipe.

To the Clerk of the United States Board of Tax Appeals:

You are hereby directed to transmit to the United States Circuit Court of Appeals, for the Third Circuit, as the record on the appeal in the above entitled cause, the following:

(1) Docket entries.

(2) Pleadings before this Board.

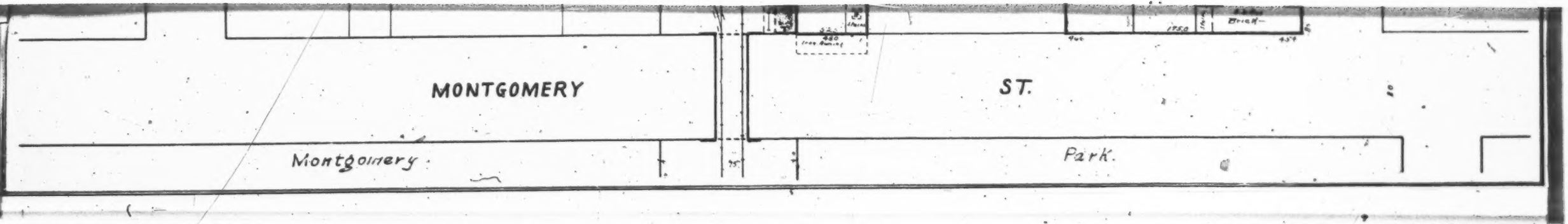
(3) Statement of record before the Board as agreed upon by attorneys for the respective parties, and the stipulation attached thereto.

(4) All of the exhibits on behalf of the petitioner, true copies of each exhibit being handed you herewith, (except Exhibit 3, and as to that exhibit only the Certificate of Incorporation and the Amendments of 1911 shall be included, and the acknowledgments and certifications shall be omitted).

• CHASE NAT'L	In May 1929 par value changed from $100 to $20 - 5 shares for one
• CHATHAM & PHENIX	In Sept 1929 par value changed from $100 to $20 - 5 shares for one
• CONT.MENTAL BK & TR	In May 1929 par value changed from $100 to $10 - 10 shares for one
• IRVING TRUST CO.	In Apr 1929 par value changed from $100 to $10 - 10 shares for one
• MORRISTOWN TRUST	In May 1929 par value changed from $100 to $25 - 4 shares for one

Monthly High and Low Prices for 1930 and Jan. 1931

Bank	Jan.	Feb.	Mar.											
Bank of America	134 - 128	134 - 126	141½-128½	140 - 129	130 - 92	100 - 95	95 - 86	104 - 94	90 - 84½	85½ - 65	65 - 62			


MONTGOMERY
ST.
Montgomery
Park.

(5) Typewritten copy of Exhibit A, and photostatic copies of Exhibits B to K, inclusive, offered by respondent.

(6) Opinion and dissenting opinion of the Board.

(7) Determination of the Board.

(8) Petition for review and assignment of errors.

(9) This praecipe.

Respectfully yours,

JAMES D. CARPENTER, JR.,
Attorney for Petitioner-Appellant.

January 8—1937.

Respondent agrees that the foregoing shall constitute the record on appeal, and waives his right to file a further praecipe.

MORRISON SHAFROTH, JR.,
Attorney for Commissioner of
Internal Revenue.

R. E. S.
1/22/37.

Certificate.

UNITED STATES BOARD OF TAX APPEALS,

WASHINGTON.

NATIONAL GROCERY COMPANY, Petitioner, v. COMMISSIONER OF INTERNAL REVENUE, Respondent.	Docket No. 76600.

I, B. D. GAMBLE, clerk of the U. S. Board of Tax Appeals, do hereby certify that the foregoing pages, 1 to 149, inclusive, contain and are a true copy of the transcript of record, papers, and proceedings on file and of record in my office as called for by the Praecipe in the appeal (or appeals) as above numbered and entitled.

In testimony whereof, I hereunto set my hand and affix the seal of the United States Board of Tax Appeals, at Washington, in the District of Columbia, this 30th day of January, 1937.

B. D. GAMBLE,
Clerk,
United States Board of Tax Appeals.

[SEAL]

UNITED STATES CIRCUIT COURT OF APPEALS
FOR THE THIRD CIRCUIT

No. 6324. March Term, 1937

NATIONAL GROCERY CO., PETITIONER

vs.

COMR. OF INTERNAL REVENUE, RESPONDENT

Appeal from the Board of Tax Appeals

And now, to-wit, this 28th day of April A. D. 1937, it is ordered that Hon. Oliver B. Dickinson, District Judge for the Eastern District of Pennsylvania, be, and he is, hereby assigned to sit in above case in order to make a full court.

JOSEPH BUFFINGTON,
Circuit Judge.

(Endorsements:) Order Assigning Hon. Oliver B. Dickinson for Argument Received & Filed Apr. 28, 1937. William P. Rowland, Clerk.

United States Circuit Court of Appeals for the Third Circuit

No. 6324. March Term, 1937

NATIONAL GROCERY COMPANY, PETITIONER

vs.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

And afterwards, to wit, the 28th day of April 1937, come the parties aforesaid by their counsel aforesaid, and this case being called for argument sur pleadings and briefs, before the Honorable Joseph Buffington and Honorable John Biggs, Jr., Circuit Judges, and Honorable Oliver B. Dickinson, District Judge, and the Court not being fully advised in the premises, takes further time for the consideration thereof,

And afterwards, to wit, on the 21st day of October 1937, come the parties aforesaid by their counsel aforesaid, and the Court, now being fully advised in the premises, renders the following decision:

United States Circuit Court of Appeals for the Third Circuit

No. 6324. March Term, 1937

NATIONAL GROCERY COMPANY, PETITIONER

v.

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Upon Petition for Review From the United States Board of Tax Appeals

Opinion

(Filed October 21, 1937)

Before BUFFINGTON and BIGGS, Circuit Judges, and DICKINSON, District Judge

BUFFINGTON, *J.*: This case concerns the compulsory distribution and penalizing of corporate profits accumulated in excess of reasonable reserves and with intent to avoid surtax taxation. The statutory authority to impose the taxes rests on the Revenue Act of 1928, c. 852, 45 Stat. 791. Eight members of the Tax Board united in an opinion imposing the tax here involved, while seven others united in a dissenting opinion.

Turning first to the above cited act, we note it provides:

"SEC. 104. Accumulation of Surplus to Evade Surtaxes.

"(a) If any corporation, however created or organized, is formed or availed of for the purpose of preventing the imposition of the surtax upon its shareholders through the medium of permitting its gains and profits to accumulate instead of being divided or distributed, there shall be levied, collected, and paid for each taxable year upon the net income of such corporation a tax equal to 50 per centum of the amount thereof, which shall be in addition to the tax imposed by section 13 and shall be computed, collected, and paid upon the same basis and in the same manner and subject to the same provisions of law, including penalties, as that tax.

"(b) The fact that any corporation is a mere holding or investment company, or that the gains or profits are permitted to accumulate beyond the reasonable needs of the business shall be prima facie evidence of a purpose to escape the surtax."

Since the taxpayer corporation in this case was created some years before the statute was enacted, it will be seen the warrant for imposing the tax and penalty is, first, that such antecedent corporation was, after the act was passed, "availed of for the purpose of preventing the imposition of the surtax upon its shareholders through the medium of permitting its gains and profits to accumulate instead of being divided or distributed," and secondly, that the fact "that the gains or profits are permitted to accumulate beyond the reason-

able needs of the business, shall be prima facie evidence of a purpose to escape the surtax."

The taxes here involved are for the year 1930, and from the above quoted terms of the law it is clear that Congress did not force the distribution with penalization of all corporate profits but only where the profits "are permitted to accumulate beyond the reasonable needs of the business." Such being the conditions warranting taxation, it follows that the basic question is whether the profits here involved were accumulated beyond the reasonable needs of its business. If this basic fact is established, then, and then only, is such accumulation by the statute made "prima facie evidence of a purpose to escape the surtax."

Turning now to the facts of this case, we note the Government called no witnesses and the proofs of the taxpayer were not contradicted. The case is clear of fraud or proof that the corporation was actuated by any purpose "of preventing the imposition of the tax upon its shareholders."

The uncontradicted proofs show that Henry Kohl, a foreigner, came to America in 1887 and was without money or property. He worked as a clerk in grocery stores for three years. By that time he had saved $217 and in 1891 became half owner in a $500 store and later on in a $250 additional one. Subsequently the partnership was ended by each partner taking one store. Thereafter Kohl bought two additional stores and was the first to use trading stamps in grocery stores. He drew nothing from his business save a bare living. In 1906 he incorporated his three stores under the name Henry Kohl Company and did business until 1911. The interesting story of the development of his business is best told in his own words.

The proofs show that dividends were declared in 1933, 1934, 1935, and 1936. None was declared in 1930, the taxable year here in question. The company accumulated bonds and stocks aggregating $2,989,452.74, which at the end of that taxable year had shrunk by more than $943,517.42. As bearing on the question of avoiding taxation it will be noted the company was in a position, if it sought to escape taxation, to have sold these securities and established a deductible loss. In that regard Kohl testified, "I did not refrain from paying dividends in the National Grocery Company in 1930 in order to avoid the payment of any government tax. I have never done that." Bearing on the corporation acquiring and holding some $2,900,000 of securities, in answer to the question, "Why did the corporation make investments in all these different kinds of stocks and bonds?" the witness testified, and as we have seen without contradiction, as follows: "To invest that money so that when we would need it we would have it. All corporations do that more or less. . . . We wanted to use it all the time. It was invested because we wanted to have the cash on hand. And those were the days there was very little investment. We had to have the money ready. What will you do with it if you don't invest it? . . . It was part of our business. We carried that money, of course, principally to have

the money on hand and get something for it. At the banks you would only get 2 per cent at that time. Of course, you don't get anything now. So we bought some stocks and bonds which we could turn over. You know, you can turn that stuff over in the morning, in a couple of hours, and you have your money if you want it. The money was invested that way so that whenever we needed the money we could sell the securities and get the money. All corporations do that." The proofs make it clear that Kohl was, so to speak, obsessed with the idea of store acquisition and this was the keynote of his actions and business life. To use a homely phrase, his plan was to acquire more stores by "plowing back" into his expanding business the profits his company made. Had he followed this course as an individual business man, instead of doing so as the sole owner of the stock of his corporation, such a course would not have subjected him to this tax. That the growth of this great business was the dominant purpose of all he did is proven by the—again uncontradicted—proof of the treasurer of the company who had worked with him for nearly forty years:

"It has been Mr. Kohl's policy from the formation of the business that he could make more money by reinvesting the earnings in the business than in any other type of investment. The reason the National Grocery Company invested money in a diversified list of stocks and bonds, was because the cash was always available when it was invested in that type of securities, and meanwhile was earning money. The Company has never been financed or expanded through borrowed money. We have never borrowed money except on short term borrowings. The Company has never sold any stock or bonds to the public. All the expansions of the business have been out of earnings. I am one of the stockholders.

"When Mr. Kohl had one store, he promised me he would have ten some day. After he had ten and he thought if I would stay a little longer maybe he would have a hundred, and that has always been his policy right along. Then as the money accumulated there was some competition that was troublesome and he expressed a desire to be able to buy them out some day.

"I believe in 1919 we had two hundred stores. At that time Mr. Kohl was figuring on having a thousand. When he got up to six and eight hundred stores his plan was to have two thousand stores. Our present warehouse was built to take care of between 1,500 and 2,000 stores. The present warehouse was built in the late twenties, and is a six-story building. The bakery would supply probably one thousand stores in its capacity when built, but we are in process of rebuilding that now in order to put in modern machinery to take care of the stores that we hope to open. When the present machinery is installed it will double our present output. As far as the size of the building goes, the ovens and machinery will supply fifteen hundred stores."

In addition to the decline in securities value in 1930, aggregating some $943,517.42, the proof is that the company's merchandise shrank

in value well on to a quarter million dollars, and the real estate declined in value one hundred and twenty-five thousand dollars. Moreover, the shares of stock in five large New Jersey banks—the company had over 8,000 shares—were unsalable during the year of bank closing, and, to use the words of a dealer, "None of the local bank stocks could have been sold on January 1, 1931. The market for bank stocks entirely disappeared in the latter part of October, November, and December 1930. They could not have been sold. They had no market value at that time." Armbruster, an experienced bank stock dealer, referring to the bank stocks owned by the National, testified: "The bank stocks could not have been liquidated in January 1930, because we had declared a condition which started around the middle of December 1929, and ended about April of 1930, where you could not trade in any of the stocks of the five large Jersey City banks."

While the personal credit of Mr. Kohl and his company built up through years, was such that, as conceded by these witnesses, the credit of the company would not have been impaired by the declaration of dividends which were suspended during 1930, yet their uncontradicted proof also is that by following the course of prudence during this panic year the surplus accumulated was not "beyond the reasonable needs of the business."

Turning then to the basic question whether the retention of its available cash in this panicky condition of the company in 1930 was reasonable, we have the testimony of other outsiders. William J. Field, president of a large local bank, former president of the New Jersey Bankers' Association, and with knowledge of the National Grocery Company, when asked whether in his opinion the capital and surplus of the National Grocery Company for the calendar year ending January 31, 1931, was in excess of the reasonable needs of the business, testified:

"I don't think it was in excess of reasonable requirements and reasonable safety of the business. The working capital at the end of 1930 was $3,700,000 odd. The working capital at the end of January 1931 was $4,500,000. We were starting on a panic or panicky conditions. No one could foretell the future at that time. The National Grocery Company had a turnover of from six to eight times its capital in the volume of business it did in those years. It is true that some of the other chain stores in the grocery lines had a turnover of from 10 to 12 per cent, but the National Grocery Company showed a much safer condition by turning over at a smaller percentage than the other companies. They had experience in previous years of rather large losses on inventory, and naturally they should keep a considerable working capital and a surplus to meet any additional losses they might encounter. . . . This company had accumulated a surplus, a good part of which was invested in stocks and bonds. After the depression, in 1929, these securities went off very considerably in market value. Many of them were what was known as over-the-counter securities. There was a large proportion of bank stocks

and it was found they went off in market value, bank stocks outside of New York City could not be sold even at the so-called market value in those times—the conditions that prevailed with bank stocks or stocks of banks located outside of New York City."

Frank C. Ferguson, president of the Hudson National Bank, after examining the balance sheets, statement of profits, and the exhibits in the case, testified:

"In my opinion for the year ending January 31, 1931, the surplus of the corporation was not in excess of the reasonable needs of the business. In my opinion it was good, sound business practice for the Company in that year not to declare any dividends, because in view of the times it was important to conserve all cash resources.

"I am familiar with the inventory of securities owned by the National Grocery Company in the year ending January 31, 1931. For the purposes of the business you would have to eliminate entirely from the statement of the National Grocery Company all the shares of stock in Jersey City and Hoboken banks, because they had no liquidity."

When asked what effect the depression had on the salability of local bank stocks, Mr. Ferguson testified:

"For a time we tried to peg the market and found it impossible. Had to let the market go. I could not sell the bank stocks of these banks with the possible exception of the Commercial Trust Company, which always maintained somewhat of a market. But the rest of the stocks, including my own bank's stock, were absolutely unsalable at any time in this period.

"As I have already stated, those securities could not have been sold nor could they have been used as collateral securities for a loan."

Yet in view of this enormous depletion and shrinking of assets, the Commissioner—and the Board following his lead—in addition to the $103,616.60 income tax paid by the corporation, assessed an alleged deficiency of $477,360.68 here involved. We find in the record no justification for the Board so doing, and it is clear the Board did not pass on the uncontradicted proofs given by the taxpayer, but based its action on the report of an investigator. Indeed, in its opinion the Board says:

"In his deficiency notice the respondent stated:

"After careful consideration of your protest dated July 19, 1932, and subsequent information furnished this office, the Bureau approves the revenue agent's conclusion that in accordance with the provisions of section 104 of the Revenue Act of 1928 your company has permitted its gains and profits to accumulate beyond the reasonable needs of the business instead of being distributed, which is construed as prima facie evidence of a purpose to prevent imposition of surtax upon its stockholders."

To our mind, this does not meet the statutory requirement. On what was the right and statutory duty of the revenue agent based? Did he have the evidence we have quoted before him? What statutory effect does his report have? The fair market value of the

securities owned on January 31, 1931, was $2,125,434.50 as against their cost of $2,989,452.74. The Board, by its own statement, considered "subsequent information furnished this office," and approved "of the Revenue agent's conclusion" and made this its warrant for imposing this tax. It construed this as prima facie evidence of a purpose to prevent imposition of surtax upon its stockholders. Acting on this foundationless prima facies, the Board drew the legal conclusion that "we are also of opinion that the evidence of record does not rebut the prima facie presumption created by the statute." This, to our mind, was a nonsequitur. The basic thing was for the Board to itself determine whether the "profits are permitted to accumulate beyond the reasonable needs of the business" and thereafter, and only thereafter, does the prima facies arise of the purpose to avoid surtax taxation. For aught that appears in the record the Board made no such finding as the Act requires, and this notwithstanding its attention was called thereto in the dissenting opinion: "It may, or may not, be significant that the respondent did not categorically find that the petitioner was 'availed of' for the interdicted purpose; but such finding must be made by the Board if it is to approve the deficiency. * * * The respondent offered no evidence, except a statement of the cost and market value of the securities prepared from the books of the petitioner and its sole stockholder." Indeed, in 82 Fed. (2d) 965 (certiorari denied in 298 U. S. 680), it was held that "so far as the finding by the Board is concerned, the facts are admitted and the finding is not a finding of fact at all but a mere conclusion which the facts do not support." In that connection see also Commissioner v. Rankin, 295 U. S. 123; The Ernest H. Meyer, 84 Fed. (2d) 496; and Tex-Penn Oil Co. v. Commissioner, 83 Fed. (2d) 518, where it is said:

"The ultimate finding is a conclusion of law or at least a determination of a mixed question of law and fact. It is to be distinguished from the findings of primary, evidentiary, or circumstantial facts. It is subject to judicial review and, on such review, the court may substitute its judgment for that of the Board."

With this lack of fact proof thus called to the Board's attention, it called no witness to testify but stood on the report of the revenue agent and the "subsequent information furnished this office."

This case, as we have said, involved no fraud or concealment. For twenty years before the Revenue Act was passed this taxpayer followed the lawful and prudent policy of "ploughing" its earnings into the expansion of its business. The expansion of its business increased its risks, and the accumulating of the earnings of profitable years was its bulwark against fires, earthquakes, floods, wars, depreciation, depression, protracted and costly strikes, boycotts, the preventing of employees from working, and the many unforeseen and unlooked for adversities to which business is subject. In this case we have the uncontradicted testimony that this great business needed the surplus it maintained. With its experience in the taxable year of 1930, with $900,000 shrinkage in its securities; with nearly a

quarter of a million dollars depreciation in its merchandise and $125,000 in its real estate, and with the market for its large bank stock holdings non existent, what man familiar with the conduct of large business operations can say it was unreasonable for the company to protect itself against emergencies? No one was called to the stand to prove the contrary and the ex parte opinion of a revenue officer, with no proof of his knowledge, ability or experience in the conduct of such a business, was no proof at all.

Without entering into further details, we limit ourselves to holding that the Tax Board had before it no proof, substantial or otherwise, to support its imposition of this penal tax. Its judgment is, therefore, reversed.

Biggs, Circuit Judge, dissenting:

I must respectfully dissent from the majority opinion of the court.

The statute under which the deficiency was here found by the Board of Tax Appeals is set forth in haec verba in the majority opinion. The penalty required by the statute may be imposed only if the corporation is found to have accumulated an unreasonable surplus with the purpose of permitting its shareholders to escape surtax. United Business Corporation of America v. Commissioner, 19 B. T. A. 809, affirmed 62 F. (2nd) 754, certiorari denied, 290 U. S. 635. The ultimate question therefore before the court in the case at bar is, did the corporation accumulate an unreasonable surplus with the purpose of enabling its sole stockholder to escape surtax?

The statute creates a presumption of such a purpose upon the part of the corporation if its gains or profits are permitted to accumulate beyond its reasonable needs. Under the statute such an accumulation is prima facie evidence of that purpose in the corporation.

An examination of the authorities convinces me that the effect of the statute creating the presumption, in the case at bar, as stated in United Business Corporation v. Commissioner, supra, is simply to make the taxpayer show its hand; or, not to mix the metaphor, to show its state of mind. In the case of A. D. Saenger, Inc. v. Commissioner, 33 B. T. A. 135, affirmed 84 F. (2nd) 23, certiorari denied, 299 U. S. 577, the Board stated that "the display of that 'hand' does not relieve the taxpayer if it discloses the state of mind the statute condemns."

A state of mind, an intent or purpose may be proved in a number of ways. An accused may state what was in his mind at the time of the commission of the act subject to penalty. Generally such a person makes it plain that his purpose was an innocent one, that he did not possess the mens rea required by the statute. Such statements are received by courts generally with some skepticism since under such circumstances avowals of innocence are much more common than declarations of guilt. The matter of proof generally is not allowed to rest upon the statements of the accused. The possession of the guilty mind or of the guilty purpose may be proven in other ways by other testimony.

In the case at bar the petitioning corporation had one stockholder, Henry Kohl. He had built the business of the corporation from the operation of three stores, to eight hundred and fifteen stores by 1931, the tax year in which the alleged deficiency occurred. He continuously contemplated the purchase or operation of additional units. His every effort was devoted to increasing the size of the petitioner's business.

He drew only sufficient salary to take care of his needs in a frugal manner. The profits of the petitioner, under Kohl's direction, were ploughed back into the business. The minority opinion of the Board and the majority opinion of the Court find the reason for the accumulation of surplus by the petitioner to be Kohl's obsession to create an ever greater chain of grocery stores and that this was the primary reason for the accumulation of the large surplus. Such may be the reason, but such reason is not incompatible with a desire to prevent the imposition of a surtax upon the sole stockholder.

There are other facts. It is a fact that when Kohl was in need of funds he procured them from the corporation by loans, frequently without interest, rather than by the payment of dividends from the assets of the corporation. It was stated in United Business Corporation v. Commissioner, supra, where the court was dealing with loans very similar in their nature to those in the case at bar, "These loans are incompatible with a purpose to strengthen the financial position of the petitioner, but entirely accord with a desire to get the equivalent of his dividends under another guise."

There was such evidence before the Board that it might find, without regard to any presumption, that the surplus of the petitioner was permitted to accumulate beyond its reasonable needs for the purpose of permitting the stockholder to avoid surtax. For example, the profits of the petitioner were very large. For the tax year under discussion that profit was over $780,000.00. In the three years preceding the tax year, the net profits of the petitioner were in excess of $800,000.00 annually. At the end of the taxable year the surplus of the corporation was more than $8,000,000.00: its liabilities were less than $1,000,000.00. Inventories on the other hand never exceeded $3,200,000.00, and accounts payable were never more than $400,000.00. Within the taxable year the petitioner loaned Kohl $140,000.00. The total of all sums loaned by the petitioner to its stockholder from the time of its incorporation until the end of the taxable year was in excess of $600,000.00.

In view of the foregoing it is my opinion that there was sufficient evidence upon which the Board could base the following findings:

"We find as a fact that the petitioner's accumulation of earnings was far in excess of the 'reasonable needs' of the corporate business." and,

"We are also of the opinion that the evidence of record does not rebut the prima facie presumption created by the statute that the accumulation of earnings beyond the 'reasonable needs of the business'

was for the purpose of preventing the imposition of the surtax upon its sole stockholder."

This finding of fact last quoted is inartistically presented, but the words used plainly indicate that the Board found that the accumulation of surplus beyond the reasonable needs of the petitioner's business was to the end that surtax might be avoided by the stockholder. In this connection it should be particularly noted that the loan of $140,000.00 by the petitioner to Kohl within the period of the taxable year did have the effect of permitting the stockholder to avoid imposition of surtax, otherwise unavoidable had the sum been paid to him as a dividend.

One question remains. Are the findings of the Board referred to findings of fact? In my opinion they are such, and, therefore, being based upon sufficient evidence cannot be disturbed. A. D. Saenger, Inc. v. Commissioner, supra; United States v. R. C. Tway Coal Sales Co., 75 F. (2nd) 336; United Business Corporation v. Commissioner, supra; R. & L., Inc. v. Commissioner, 84 F. (2nd) 721; Helvering v. Rankin, 295 U. S. 123, 131.

The judgment of the Board of Tax Appeals should be affirmed.

A true Copy:

Teste:

Clerk of the United States Circuit Court of Appeals for the Third Circuit.

United States Circuit Court of Appeals for the Third Circuit

No. 6324. March Term, 1937

NATIONAL GROCERY COMPANY, PETITIONER

vs.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Appeal from the United States Board of Tax Appeals

This cause came on to be heard on the transcript of record from the United States Board of Tax Appeals, and was argued by counsel.

On consideration whereof, it is now here ordered, adjudged, and decreed by this Court that the order or decree of the said Board of Tax Appeals in this cause be, and the same is hereby, reversed.

PHILADELPHIA, *October 21, 1937.*

Per Curiam.

BUFFINGTON, *Circuit Judge.*

(Endorsements:) Order Reversing Decree Received & Filed Oct. 21, 1937. William P. Rowland, Clerk.

UNITED STATES OF AMERICA,

Eastern District of Pennsylvania, Third Judicial Circuit, Sct.:

I, Wm. P. Rowland, Clerk of the United States Circuit Court of Appeals for the Third Circuit, do hereby certify the foregoing to be a true and faithful copy of the original Transcript of Record and proceedings in this Court in the case of National Grocery Co., Petitioner, vs. Commissioner of Internal Revenue, Respondent, No. 6324, on file, and now remaining among the records of the said Court, in my office.

In testimony whereof, I have hereunto subscribed my name and affixed the seal of the said Court, at Philadelphia, this 4th day of January in the year of our Lord one thousand nine hundred and thirty-eight and of the Independence of the United States the one hundred and sixty-second.

[SEAL]

WM. P. ROWLAND,
Clerk of the U. S. Circuit Court of Appeals, Third Circuit.

U. S. GOVERNMENT PRINTING OFFICE: 1938

Supreme Court of the United States

Order allowing certiorari

Filed February 28, 1938

The petition herein for a writ of certiorari to the United States Circuit Court of Appeals for the Third Circuit is granted. And it is further ordered that the duly certified copy of the transcript of the proceedings below which accompanied the petition shall be treated as though filed in response to such writ.

Mr. Justice Reed took no part in the consideration or decision of this application.

U. S. GOVERNMENT PRINTING OFFICE: 1938

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In the Supreme Court of the United States

OCTOBER TERM, 1937

No. —

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

NATIONAL GROCERY COMPANY

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT

The Solicitor General, on behalf of Guy T. Helvering, Commissioner of Internal Revenue, prays that a writ of certiorari issue to review the judgment of the United States Circuit Court of Appeals for the Third Circuit entered in the above entitled cause on October 21, 1937.

OPINIONS BELOW

The opinion of the Board of Tax Appeals, together with the dissenting opinion (R. 17–32), is reported in 35 B. T. A. 163. The opinion of the Circuit Court of Apeals (R. 172–180) is not yet reported.

JURISDICTION

The judgment of the Circuit Court of Appeals for the Third Circuit was entered on October 21, 1937 (R. 180). The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether the Circuit Court of Appeals for the Third Circuit departed from the accepted and usual course of judicial proceeding in its decision and opinion concluding that there was no evidence to sustain the determination of the Board of Tax Appeals that respondent was availed of during the taxable year for the purpose of preventing the imposition of the surtax upon its sole stockholder.

STATUTE AND REGULATIONS INVOLVED

The statute and regulations involved are set forth in the Appendix, *infra*, pp. 23–28.

STATEMENT

The Commissioner determined that in the taxable year ended January 31, 1931, the respondent had permitted its profits to accumulate beyond the reasonable needs of its business instead of being distributed, which he construed as prima facie evidence of the purpose to prevent the imposition of the surtax upon its stockholder, and accordingly determined a deficiency in the amount of $477,360.68 (R. 14).

The Board sustained this determination (R. 33). In its opinion, the Board stated that it concluded from the evidence before it that the respondent's accumulations of earnings in the taxable year were far in excess of the reasonable needs of the corporate business (R. 22–23); that the evidence did not overcome the resultant statutory presumption; the respondent was availed of for the interdicted purpose during the fiscal year ended January 31, 1931 (R. 24).

The findings of the Board may be summarized as follows (R. 18–21):

Since 1908 the respondent corporation, all of whose shares were beneficially owned by its organizer, one Kohl, had operated a chain of grocery stores on a "cash and carry" basis. Its annual profits in the fiscal years ended January 31, 1923, to January 31, 1931, had been in excess of $500,000, and for the last four of these $818,043.54, $870,144.92, $806,507.32, and $786,466.98, respectively, and in these years it had operated 715, 782, 799 and 815 stores, respectively. In the same period it had paid Kohl a salary of $2,000 a week. For a long time the respondent had invested its surplus profits in stocks and bonds in order to obtain a greater return therefrom than would have been possible from bank deposits and with the thought in mind of realizing cash thereon for the purpose of expanding its chain of grocery stores at any time

desired. The only dividends it had paid up to the end of the taxable year were two of $25,000 each, one in 1917 and one in 1918. On the other hand, the respondent had advanced $394,100 to Kohl up to January 26, 1925, on notes bearing interest, although no interest had ever been charged or paid thereon. Thereafter it made further loans to him on notes bearing no interest, so that at the end of the taxable year it had loaned him $610,000. In that year the respondent loaned Kohl $140,000, $40,000 of which was to enable him to acquire a house in Florida, and $100,000 to make a personal charitable contribution. A part of the loans was canceled in subsequent years by dividends declared after the end of the taxable year, a balance of $424,000 remaining unpaid as late as April 23, 1936. The respondent's balance sheet for the fiscal years ended January 31, 1928, to January 31, 1931, inclusive, shows as follows:[1]

[1] The tabulation following is a part of the respondent's balance sheet, 1907 to 1935 (Exhibit 6, R. 136–137).

	Fiscal years ended—			
	1/31/28	1/31/29	1/31/30	1/31/31
ASSETS				
Cash	$659,734.40	$890,397.59	$1,332,332.28	$1,405,961.04
Notes receivable	424,100.00	460,000.00	470,000.00	610,000.00
Accounts receivable	1,888.82	3,975.19	26,816.37	3,220.85
Inventories	2,615,057.67	2,917,716.55	3,189,396.72	2,812,939.16
Mortgage	59,000.00	59,000.00	59,000.00	59,000.00
Bonds	256,114.76	96,820.30	59,435.00	313,291.27
Stocks	2,169,687.62	2,318,074.13	2,720,283.07	2,676,061.47
Other	6,236.39	7,425.08	10,150.89	20,686.18
Deferred	33,338.64	25,685.23	31,875.79	29,687.74
Permanent	1,542,129.00	1,501,193.83	1,345,976.63	1,177,489.43
Total	7,767,287.90	8,280,287.90	9,245,266.75	9,108,437.14
LIABILITIES				
Notes payable and mortgages	1,008,750.00	700,000.00	790,000.00	
Accounts payable	258,889.61	270,318.54	371,121.96	269,140.49
Accrued	7,742.15	7,385.56	19,757.11	7,411.70
Reserve income tax	93,933.45	72,035.56	52,592.97	51,330.42
Reserve insurance	417,797.77	491,032.34	565,970.45	641,588.99
Capital stock and surplus	5,980,174.92	6,739,515.90	7,445,824.26	8,138,965.54
Total	7,767,287.90	8,280,287.90	9,245,266.75	9,108,437.14

The fair market value of the securities owned by the respondent on January 31, 1931, was $2,125,434.50, as against the cost of $2,989,452.74, a difference of $864,018.24. In conclusion, the Board found that, during the fiscal year ending January 31, 1931, the respondent was availed of for the interdicted purpose.

The Circuit Court of Appeals for the Third Circuit, in an opinion written by Judge Buffington, Judge Biggs dissenting, reversed the Board's decision, on the ground that the Board had relied solely on the report of a revenue agent and other information furnished to the Commissioner; that the Board had failed to pass on what the court considered the

uncontradicted proof of the respondent, and that this uncontradicted testimony showed that the business needed the surplus which respondent maintained. Without entering into further details, it limited itself to holding that the Board had before it no proof, substantial or otherwise, to support the imposition of the "penal tax."

SPECIFICATION OF ERRORS TO BE URGED

The Circuit Court of Appeals erred—

1. In finding, concluding, and holding that the Board of Tax Appeals had failed to pass upon what the court considered to be the uncontradicted proofs made by the respondent, and that, when this was called to the Board's attention, it had failed to call witnesses but had based its finding solely upon a report made to the Commissioner by a revenue agent of an *ex parte* investigation made by him, which is not in evidence, and upon certain subsequent information furnished the Commissioner, the nature of which is not disclosed by the evidence.

2. In failing to remand the proceeding to the Board for a rehearing, if it is true that the Board was guilty of such an arbitrary disposition of the issues.

3. In usurping the power of administrative decision by finding the facts from conflicting evidence, determining the issue itself, and substituting such determination for that of the administrative body.

4. In rejecting a finding of fact made by the Board that, in the fiscal year ended January 31, 1931, the respondent's gains and profits were permitted to accumulate beyond the reasonable needs of its business, where it does not appear that the evidence, with every reasonable inference that may be drawn therefrom in the petitioner's favor, is insufficient to sustain such finding, and in making its own contrary finding upon the basis of testimony of certain facts which, standing alone, would support such contrary finding; and, in so doing, failing to consider evidence of an array of facts, which, together with proper inferences to be drawn therefrom, discounts the testimony which the court relied upon and supports the finding of the Board.

5. In rejecting a finding of fact made by the Board that the respondent has failed to overcome the statutory presumption arising from the fact that it had permitted its gains and profits to accumulate beyond the reasonable needs of its business, where it does not appear that the evidence, with every reasonable inference that may be drawn therefrom in favor of the petitioner, is insufficient to sustain such finding.

6. In rejecting a finding of fact made by the Board that the respondent was availed of for the interdicted purpose, where it does not appear that the evidence, with every reasonable inference that

may be drawn therefrom in the petitioner's favor, is insufficient to sustain it.

6. In entering a judgment the effect of which is either to expunge the deficiency determined by the Board or to require the Board to do so.

7. In reversing the Board's order of redetermination of the deficiency in the tax of $477,360.68.

REASONS FOR GRANTING THE WRIT

In its review of the decision of the Board of Tax Appeals, the court below has so far departed from the accepted and usual course of judicial proceeding as to call for an exercise of this Court's powers of supervision.

Specifically, the court below wrongfully charged the Board (a) with having neglected to consider what the court considered to be the uncontradicted proofs given by respondent; (b) with having based its action solely on the revenue agent's report and other information furnished to the Commissioner, none of which was in evidence; (c) with having failed itself to determine whether the profits were accumulated beyond the reasonable needs of the business, and with having failed to make the finding required by the statute, though the dissenting members called attention to this, but with having instead construed the revenue agent's report and the other information furnished the Commissioner as *prima facie* evidence of a purpose to prevent the

imposition of a surtax upon respondent's stockholder, and with acting on this allegedly foundationless *prima facies* in drawing the conclusion that "We [the Board] are also of the opinion that the evidence of record does not rebut the prima facie presumption created by the statute" (R. 23).

Further than this, instead of remanding the case, so that the Board could consider the respondent's evidence which it had allegedly neglected on the first hearing, the court below, while ostensibly reviewing the facts to determine whether there was any evidence to sustain the Board's findings of an accumulation beyond the reasonable needs of the business and of the interdicted purpose, proceeded to find the facts from conflicting testimony and to determine the issues itself contrary to the finding of the Board. Moreover, in so doing, it culled from the evidence certain facts, which, standing alone, would support such a contrary finding and, by the same token, failed to consider an array of facts, which, together with proper inferences to be drawn therefrom, not only discounts the testimony the court relied upon, but amply justifies the finding of the Board.

The only issue before the court was whether the evidence, with the inferences reasonably to be drawn therefrom in petitioner's favor, supported the findings and judgment of the Board of Tax Ap-

peals against respondent.[2] What the court should have done, but did not do, was to review all the evidence in the case, to determine whether there was any evidence which, with the inferences favorable to petitioner reasonably to be drawn therefrom, supported the Board's judgment in his favor. Although the court said that it had found no proof before the Board which supported its determination, actually it proceeded with the case as though the findings and decision had been in the *respondent's* favor, and selected from the evidence and discussed such facts as would have supported such a judgment. Thus the court has usurped the power of administrative decision and substituted its judgment for that of the administrative body.

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1. The court based its result in large part upon a grave misinterpretation of the Board's opinion. The court said that the Board had relied solely on

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[2] Whether the petitioner permitted gains to accumulate beyond the reasonable needs of its business, and whether the petitioner was availed of for the purpose of preventing the imposition of a surtax upon its shareholders through the accumulation of gains, are clearly questions of fact, upon which the Board's findings are conclusive if supported by the evidence. *United Business Corp.* v. *Commissioner*, 62 F. (2d) 754 (C. C. A. 2d), certiorari denied, 290 U. S. 635; *United States* v. *R. C. Tway Coal Sales Co.*, 75 F. (2d) 336 (C. C. A. 6th); *A. D. Saenger, Inc.* v. *Commissioner*, 84 F. (2d) 23 (C. C. A. 5th), certiorari denied, 299 U. S. 577; *R. & L., Inc.* v. *Commissioner*, 84 F. (2d) 721 (C. C. A. 5th); *Commissioner* v. *Fisher & Fisher*, 84 F. (2d) 996 (C. C. A. 2d); *Commissioner* v. *Cecil B. De Mille Productions*, 90 F. (2d) 12 (C. C. A. 9th), certiorari denied, October 11, 1937; *Almours Securities, Inc.* v. *Commissioner*, 91 F. (2d) 427 (C. C. A. 5th), certiorari denied, January 10, 1938.

the revenue agent's report and other information furnished to the Commissioner, and construed it as *prima facie* evidence of respondent's purpose to prevent imposition of a surtax upon its shareholders, that the Board had not itself determined whether the profits were permitted to accumulate beyond the reasonable needs of the business or made a finding to this effect.[3] In these statements, the court erred. The error is important because it was in large part due to this analysis that the court disregarded the true basis of the Board's decision and much of the evidence introduced before and considered by the Board. Although the Board did set out the Commissioner's deficiency notice, which in

[3] Since the court stated that the "basic thing was for the Board to itself determine whether the 'profits are permitted to accumulate beyond the reasonable needs of the business'" and then observed that "the Board made no such finding as the Act requires" (R. 177), apparently the court felt that the finding omitted by the Board was that pertaining to accumulation beyond the reasonable needs of the business. But the court then stated the Board failed to make the required finding "notwithstanding its attention was called thereto in the dissenting opinion" (R. 177). Examination of the paragraph quoted from Member Mellott's dissent (R. 25) discloses that he had reference to the finding of the ultimate purpose to escape surtaxes rather than the intermediate fact of accumulation beyond the reasonable needs of the business. Moreover, he was merely calling attention to the Commissioner's failure explicitly to make this finding. He decided that he would not concur in the Board's finding, but by no means implied that the Board did not make such a finding.

Whichever finding it was that the court thought had not been made by the Board, it is apparent that the Board made both findings, and each instance upon its own inferences from evidence introduced before it. See *infra*, pp. 12–13.

turn advised the taxpayer that, upon the basis of information furnished that office the Bureau approved the conclusion of the revenue agent that there existed an accumulation of profits beyond the reasonable needs of the business, the Board nowhere indicated that it was relying on the revenue agent's report or on other information furnished the Bureau, and it certainly negatived any suggestion that the deficiency notice and its contents constituted the sole basis of its decision. It is abundantly clear that though the Board may have arranged its opinion "inartistically" (cf. R. 180), it did determine for itself and find as a fact, upon the evidence before it, that the profits had been accumulated beyond the reasonable business needs (R. 22–23); that it then examined the other evidence and determined therefrom that the statutory presumption of the purpose to prevent surtaxes had not been rebutted and indeed had been corroborated (R. 23–24), and that it concluded with an express finding of the interdicted purpose (R. 24).

The Board concisely summed up the evidence on which it primarily relied in reaching its conclusion that the accumulation of profits was beyond the reasonable needs of the business. It adverted to several factors in the evidence (R. 22–23): (a) Since the time prior to 1922 when the taxpayer began to invest in stocks and bonds its holdings have greatly increased. There was also, up to 1929, a very large increase in the market value of the securities acquired. (b) Since 1929, the petitioner has not greatly expanded its grocery business.

(c) Its large profits have not been distributed as dividends but have been mostly invested in securities. (d) Taxpayer's balance sheets for the beginning and the end of the taxable year were set out. (Each shows current assets far in excess of actual liabilities. Indeed, each shows cash on hand alone as far in excess of actual liabilities.) (e) Taxpayer's actual surplus at January 31, 1931, was $7,938,965.54. (f) The Board disposed of the taxpayer's contention that the surplus was of benefit in obtaining credit at banks and in enabling it to purchase merchandise at low prices, finding from the evidence that the taxpayer's credit had been excellent and that it did not obtain lower rates of interest because of a large investment in stocks and bonds.

Only then did the Board turn to a consideration of whether the evidence rebutted the statutory presumption attending this finding of the Board, concluding that it did not, since the evidence showed that Kohl personally needed some of the profits in that year, had prior thereto borrowed $470,000 from the company without paying interest, and had increased his borrowings by an additional $140,000 in the taxable year with the result that there was an escape of the surtax upon (at least) that amount (R. 23–24).

2. Instead of affirming the Board's decision on the basis of these facts to which the Board adverted and also on the basis of other evidence in the record (see *infra*, p. 16 *et seq.*), the court proceeded to decide the issues of fact itself.

Instead, the court dwelt at length upon the history of the respondent's "cash and carry" business, as testified to by Kohl, and upon his testimony and that of other witnesses called by the taxpayer to the effect that in their opinion the accumulations were reasonably necessary (1) in the expansion of its grocery business, (2) in the conduct of that business, and (3) because of the depreciation in the value of its investments during the depression. Upon the basis of such testimony, the court reversed the Board's findings of fact.

The signal objection to the court's approach is the fact that in effect it disposed of the case in accordance with its own inferences from the evidence. The opinion testimony of respondent's witnesses at most pointed to a different result from the evidence discussed by the Board, and should not have been given controlling weight by the court. It is only the trier of the facts who may choose between conflicting inferences which arise from different facts. "It is the function of the Board to weigh the evidence and declare the result." *Elmhurst Cemetery Co.* v. *Commissioner,* 300 U. S. 37, 40.

Moreover, in view of other evidence in the record which was not specifically discussed by the Board, it can not be said that the evidence recited by the court was truly "uncontradicted." The Government did not formally introduce opposing opinion testimony, but this was not necessary; testimony may carry its own refutation or modification, or

may be explained away by the answers of the witness himself on cross-examination. Surely the Board was not bound by the mere denial of the interdicted purpose. Besides, the development in the record of the actual status of respondent's business consists largely of joint exhibits. Several of the exhibits formally introduced by respondent were prepared by the Government (R. 56), offered at the Government's request (R. 57, 59), or with the Government's prior approval (R. 48, 53, 56), in a joint effort to facilitate the conduct of the trial.

In culling from the record testimony which, standing alone, tends to support its finding, the court overlooked the following array of facts which, together with proper inferences to be drawn therefrom, discounts the testimony the court relied upon, and amply justifies the finding of the Board. These facts indicate that a sizable portion of respondent's profits for the taxable year, shown on its books (after deducting Kohl's salary of $104,000 and its income taxes of $103,616.60) as $682,550.38,[4] could have been declared as a dividend without curbing in the slightest the reasonable needs of the business, and are as follows:

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[4] The net taxable income, upon which the tax was based, as shown in Exhibit A, attached to the respondent's petition filed with the Board, was $954,645.62. The correctness of this figure is not in controversy. The Board, in its finding (R. 18), used the book figure of $786,466.98, which was apparently derived from the books, and may represent a slight arithmetical error of $300 in adding $682,550.38 and $103,616.60, the correct sum of which is $786,166.98.

(1) The accumulations were not needed to acquire new stores. Respondent's policy was merely to rent stores, not to purchase the real estate on which they were located (R. 68). Only $5,000 was needed to acquire and finance each new store (R. 68–69). During the taxable year respondent paid off all its bank loans, $790,000, decreased its accounts payable by more than $100,000 and its accrued expenses by more than $12,000 (Exhibit 6, R. 136–137). Yet it had left a working capital of $4,500,000, according to its witness Field (R. 86), and though his mode of estimate is not set out, his figure is, if erroneous at all, too small.[5] Since re-

[5] Field stated that the working capital at the end of 1930 was $3,700,000-odd, and at the end of January 1931 was $4,500,000.

The normal signification of "net working capital" is the excess of current assets over current liabilities. Paton, Accountants' Handbook (2d ed. 1932), p. 19. The following computation of working capital is based on Exhibit 6, R. 137.

	Year Ending—	
	1/31/30	1/31/31
Current Assets:		
Cash	$1,332,332.28	$1,405,961.04
Notes Receivable	470,000.00	610,000.00
Accounts Receivable	26,816.37	3,220.85
Merchandise Inventory	3,189,396.72	2,812,939.16
Mortgage	59,000.00	59,000.00
Bonds and stocks	2,779,718.07	2,989,452.74
Total current assets	7,857,263.44	7,880,573.79
Current Liabilities:		
Notes Payable	790,000.00	
Accounts Payable	371,121.96	269,140.49
Accrued Expenses	19,757.11	7,411.70
Total current liabilities	1,180,879.07	276,552.19
Working capital	6,676,384.37	7,604,021.60

spondent had $1,405,961.04 cash in the bank, and current liabilities of only $276,552.19 (R. 137), it is obvious that respondent could have paid its current liabilities in full in cash, could in addition have acquired and financed 100 additional stores with cash, and still have had left a working capital of at least $3,723,447.81, of which $629,408.85 would have been in cash.

(2) The accumulations were not needed in the respondent's grocery business. The testimony considered by the court with respect to this point is even more vague than the testimony regarding expansion. The court quoted Mr. Field's references to "panicky conditions," to the company's turnover, to the necessity for "a considerable working capital and a surplus to meet any additional losses they might encounter" (apparently on inventory).

Even if account is taken of the depreciation in the value of the stocks and bonds, and their book value is replaced by fair market value (which, according to respondent's own estimate (R. 61–62, 146), was $2,859,217.25 as of January 31, 1930, and $2,125,434.50 as of January 31, 1931), the working capital is still seen to be $6,755,883.55 on January 31, 1930, and $6,740,003.36 on January 31, 1931, much higher than Field's figures.

Field may have obtained his figures by eliminating all consideration of stocks, bonds, and mortgages, for, upon that hypothesis, the working capital figures become $3,837,666.30 on January 31, 1930, and $4,555,568.86 as of January 31, 1931. There seems to be no warrant, however, for excluding from "current assets" an item of investments which respondent claims to have acquired merely in order to have on hand an equivalent of cash.

In discussing respondent's working capital needs, it may first be noted that its "cash and carry" system rendered unnecessary as large a working capital as would be needed by a concern extending credit. Thus, the apparently formidable item of respondent's purchases, amounting to about $20,000,000 for the year in question (R. 141), is easily explained in view of the fact that respondent turned its stock over *on a cash basis* from 6 to 8 times a year (R. 86). In this way, it received some $25,000,000 from its merchandise sales (R. 7). It is apparent that respondent's working capital far exceeded its reasonable needs. Field's minimum estimate of respondent's working capital on January 31, 1931, as $4,500,000 (which at least takes into consideration depreciation of both merchandise[6] and securities, if it does not actually eliminate them entirely, see *supra,* note 5) bears a ratio to current

[6] The difference between inventory for January 31, 1930, and January 31, 1931, cannot be regarded solely as depreciation. Kohl testified that everything declined in value in 1930 and the petitioner's witness Anna Mullins, the treasurer of the company, testified that there was a "decline" in the petitioner's merchandise inventories from $200,000 to $250,000. If we consider the fact that there was a complete turnover in its capital 6 or 8 times in that year, involving purchases of merchandise in excess of $19,000,000, the inference seems inescapable that much of the decline referred to resulted from new purchases in the course of the year at lower prices rather than from a decline in the value of goods that had been purchased in prior years at higher prices.

liabilities of 15 to 1, while the ratio of cash to such liabilities was 5 to 1. As to Field's fears with respect to additional losses on inventory, if the merchandise had declined in value by half—some $1,400,000—working capital would still be more than ten times as large as current liabilities.

The court below did not rest content with the explanations of respondent's witnesses. It added a word of its own, and regarded the accumulations as respondent's bulwark against fires, earthquakes, floods, ~~etc., were probable in New Jersey, or ex-~~ WARS, STRIKES, BOYCOTTS AND A HOST OF UNFORE—
seen calamities. None of the witnesses stated that the profits were accumulated for these purposes, and none of them even suggested that earthquakes, floods, etc., were probable in New Jersey, or expensive to insure against, or that in 1930 the respondent's labor relations were unsatisfactory. Indeed, with respect to the only fears that the company deemed real and reasonable (fire, burglary, etc.), it had started its own self-insurance reserves (R. 60, 144), which it carried as a liability on its balance sheets (R. 137).

(3) The accumulations were not needed because of the depreciation in value of the securities or inventories. Computations with respect to working capital making allowance for depreciation still show an unreasonable accumulation. Moreover, on cross-examination, both Kohl and the company treasurer explicitly testified that neither an in-

crease nor decrease of the petitioner's assets had anything to do, practically speaking, with the declaration of dividends. (R. 74, 83, 84.) Mr. Field and Mr. Ferguson, bankers called as witnesses by respondent, both testified that the company could have declared a dividend in 1930 of $100,000, without impairing its business (R. 90, 94). Indeed Field testified that respondent's credit was "as good today as it was ten years ago" though in the ~~four~~ FIVE years subsequent to the taxable year in question, the petitioner had paid $400,000 in dividends out of a much diminished net profit of $1,341,382.42 (R. 133) [7]

3. Furthermore, there are other facts in the record, apart from those showing that the accumulations were beyond the reasonable needs of the business, which indicate the respondent's real purpose, and support the Board's result. Thus, the court entirely ignored the consideration that Kohl used the respondent corporation as his "pocketbook." By January 31, 1930, respondent loaned to Kohl $470,-

[7] See the following table derived from Exhibit 4 (R. 133):

Year ending January 31	Net profits after deducting Kohl's salary & Inc. taxes	Dividends declared	Left for accumulation
1931—1/31/32	$535,947.67	$100,000.00	$435,947.67
1932—1/31/33	132,991.35	100,000.00	32,991.35
1933—1/31/34	111,211.91	100,000.00	11,211.91
1934—1/31/35	368,685.50	300,000.00	68,685.50
1935—1/31/36	202,545.99	200,000.00	2,545.99
Total	1,341,382.42	800,000.00	541,382.42

000, partly on demand notes bearing no interest and partly on notes on which no interest has ever been charged or paid (R. 19). During the taxable year, respondent loaned to Kohl an additional $140,000, on notes bearing no interest, in order that he might acquire a house in Florida and make a charitable contribution (R. 20, 24). These loans, taken together with the act that since 1925 respondent has paid Kohl a salary of over $100,000 a year, deductible on its income tax return, indicate that disbursements were made to him upon the basis of his needs and not upon the basis of what the petitioner could reasonably have disbursed. Compare R. 66.

4. Finally, it should be noted that though the court criticized the Board for failing to consider certain evidence which the court deemed persuasive, it reversed the judgment outright instead of remanding the cause so that the Board could consider and weigh that evidence. Clearly the court below has disregarded the injunction of this Court in *Hulburd* v. *Commissioner,* 296 U. S. 300, 306, that the court is "without power to choose between conflicting inferences unless only one was possible, or to try the case *de novo.*" Compare *Helvering* v. *Rankin,* 295 U. S. 123.

CONCLUSION

For the foregoing reasons it is submitted that this is clearly a case of usurpation by an appellate court of the fact-finding function of the Board of

Tax Appeals. It is respectfully urged that this petition for a writ of certiorari should be granted.

GOLDEN W. BELL,
Acting Solicitor General.

January 1938.

APPENDIX

Revenue Act of 1928, c. 852, 45 Stat. 791:

SEC. 104. ACCUMULATION OF SURPLUS TO EVADE SURTAXES.

(a) If any corporation, however created or organized, is formed or availed of for the purpose of preventing the imposition of the surtax upon its shareholders through the medium of permitting its gains and profits to accumulate instead of being divided or distributed, there shall be levied, collected, and paid for each taxable year upon the net income of such corporation a tax equal to 50 per centum of the amount thereof, which shall be in addition to the tax imposed by section 13 and shall be computed, collected, and paid upon the same basis and in the same manner and subject to the same provisions of law, including penalties, as that tax.

(b) The fact that any corporation is a mere holding or investment company, or that the gains or profits are permitted to accumulate beyond the reasonable needs of the business, shall be prima facie evidence of a purpose to escape the surtax.

(c) As used in this section the term "net income" means the net income as defined in section 21, increased by the sum of the amount of the dividend deduction allowed under section 23 (p) and the amount of the interest on obligations of the United States issued after September 1, 1917, which would be subject to tax in whole or in part in the hands of an individual owner.

(d) The tax imposed by this section shall not apply if all the shareholders of the cor-

poration include (at the time of filing their returns) in their gross income their entire distributive shares, whether distributed or not, of the net income of the corporation for such year. Any amount so included in the gross income of a shareholder shall be treated as a dividend received. Any subsequent distribution made by the corporation out of the earnings or profits for such taxable year shall, if distributed to any shareholder who has so included in his gross income his distributive share, be exempt from tax in the amount of the share so included.

Subdivisions (a) and (b) of Section 220 of the Revenue Act of 1924, c. 234, 43 Stat. 253, and subdivisions (a) and (b) of Section 220 of the Revenue Act of 1926, c. 27, 44 Stat. 9, are substantially identical with subdivisions (a) and (b) of Section 104 of the Revenue Act of 1928.

Treasury Regulations 74, promulgated under the Revenue Act of 1928:

> ART. 541. *Taxation of corporation utilized for evasion of surtax.*—Section 104 is designed to discourage the formation or use of a corporation for the purpose of preventing the imposition of surtaxes upon its shareholders, through the device of permitting its gains and profits to accumulate instead of being distributed. If a domestic or foreign corporation is so formed or availed of, it is subject to a tax at the rate of 50 per cent upon its net income in addition to the tax imposed by section 13. However, the additional tax at the rate 50 per cent does not apply for 1928 or any subsequent taxable year if all the shareholders of the corporation include (at the time of filing their returns) in their gross income their entire dis-

tributive share, whether distributed or not, of the net income of the corporation for such year or years. Any amount so included in the gross income of a shareholder shall be treated as a dividend received, and any subsequent distribution made by the corporation out of the earnings or profits for such taxable years shall, if distributed to any shareholder who has so included in his gross income his distributive share, be exempt from tax in the amount of the share so included.

ART. 542. *Purpose to escape surtax:*— Prima facie evidence of a purpose to escape the surtax exists where a corporation is a mere investment company, where a corporation has practically no business except holding stocks, securities, or other property and collecting the income therefrom or investing therein, or where a corporation other than a mere holding or investment company permits its gains and profits to accumulate beyond the reasonable needs of the business. The statutory presumption that a mere holding or investment company is subject to the additional tax imposed by section 104 may be overcome if the corporation can show, either by reason of the fact that it distributed a large portion of its earnings for the year in question, or that its stock was held not by the members of a family or of a small group but by a large number of persons and in comparatively small blocks, or by other evidence, that it was not availed of for the purpose of preventing the imposition of the surtax upon its shareholders.

The business of a corporation is not merely that which it has previously carried on, but includes in general any line of business which it may legitimately undertake.

However, a radical change of business when a considerable surplus has been accumulated may afford evidence of a purpose to escape the surtax. When one corporation owns the stock of another corporation in the same or a related line of business and in effect operates the other corporation, the business of the latter may be considered in substance the business of the first corporation. Gains and profits of the first corporation put into the second through the purchase of stock or otherwise may therefore, if a subsidiary relationship is established, constitute employment of the income in its own business. To establish that the business of one corporation can be regarded as including the business of another it is ordinarily essential that the first corporation own substantially all of the stock of the second. Investment by a corporation of its income in stock and securities of another corporation is not without anything further to be regarded as employment of the income in its business.

ART. 543. *Unreasonable accumulation of profits.*—An accumulation of gains and profits is unreasonable if it is not required for the purposes of the business, considering all the circumstances of the case. It is not intended, however, to prevent reasonable accumulations of surplus for the needs of the business. No attempt can be made to enumerate all the ways in which gains and profits of a corporation may be accumulated for the reasonable needs of the business. Distributions made by a corporation shortly after the close of its taxable year shall be taken into consideration in determining the reasonableness of the amount of earnings and profits of the corporation retained by it for such year. Undistributed income is

properly accumulated if invested in increased inventories or additions to plant reasonably needed by the business. It is properly accumulated if retained for working capital required by the business or in accordance with contract obligations placed to the credit of a sinking fund for the purpose of retiring bonds issued by the corporation. In the case of a banking institution the business of which is to receive and loan money, using capital, surplus, and deposits for that purpose, undistributed income actually represented by loans or reasonably retained for future loans is not accumulated beyond the reasonable needs of the business. The nature of the investment of gains and profits is immaterial if they are not in fact needed in the business. It is an unreasonable accumulation of gains and profits by corporations with the purpose of enabling their shareholders to escape surtaxes on such gains and profits which subjects such corporations to the additional tax imposed by section 104. Among other things, the financial condition of the corporation at the close of the taxable year and the manner in which its funds are invested at that date, determine the reasonableness of the accumulations.

For the purpose of section 104 the term "net income" means the net income of the corporation as defined in section 21 increased by the sum of (1) the amount received as dividends and allowed as a deduction by section 23 (p), plus (2) the amount of interest on obligations of the United States issued after September 1, 1917, which would be subject to tax in whole or in part in the hands of an individual owner. The Commissioner, or any collector upon direction

from the Commissioner, may require any corporation to furnish a statement of its accumulated gains and profits, the name and address of, and number of shares held by, each of its shareholders, and the amounts that would be payable to each, if the income of the corporation were distributed. (See section 149 (c).)

Articles 352 and 353 of Treasury Regulations 65 and Articles 352 and 353 of Treasury Regulations 69 are substantially identical with Articles 542 and 543 of Treasury Regulations 74.

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In the Supreme Court of the United States

OCTOBER TERM, 1937

No. 723

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

NATIONAL GROCERY COMPANY

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT

BRIEF FOR THE PETITIONER

OPINIONS BELOW

The opinion of the Board of Tax Appeals, together with the dissenting opinion (R. 17–32), is reported in 35 B. T. A. 163. The opinion of the Circuit Court of Appeals for the Third Circuit (R. 172–180) is reported in 92 F. (2d) 931.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on October 21, 1937 (R. 180). The petition for certiorari was filed January 20, 1938, and was granted February 28, 1938. The jurisdiction of this Court is conferred by Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether the court below departed from the accepted and usual course of judicial proceedings in its decision and opinion concluding that there was no evidence to sustain the determination of the Board of Tax Appeals that respondent was availed of during the taxable year for the purpose of preventing the imposition of the surtax upon its sole stockholder.

STATUTE AND REGULATIONS INVOLVED

The statute and regulations involved are set forth in the Appendix, *infra*, pp. 28–32.

STATEMENT

The Commissioner determined that in the taxable year ended January 31, 1931, the respondent had permitted its profits to accumulate beyond the reasonable needs of its business instead of being distributed, which he construed as prima facie evidence of the purpose to prevent the imposition of the surtax upon its stockholder, and accordingly determined a deficiency in the amount of $477,360.68 (R. 14).

The Board sustained this determination (R. 33). In its opinion the Board stated that it concluded from the evidence before it (1) that the respondent's accumulations of earnings in the taxable year were far in excess of the reasonable needs of the corporate business (R. 22–23); (2) that the evidence did not overcome the resultant statutory pre-

sumption; and (3) that the respondent was availed of for the interdicted purpose during the fiscal year ended January 31, 1931 (R. 24).

The findings of the Board may be summarized as follows (R. 18–21):

Since 1908 the respondent corporation, all of whose shares were beneficially owned by its organizer, one Kohl, had operated a chain of grocery stores on a "cash and carry" basis. Its annual profits in the fiscal years ended January 31, 1923, to January 31, 1931, had been in excess of $500,000, and for the last four of these $818,043.54, $870,-144.92, $806,507.32, and $786,466.98, respectively; in these years it had operated 715, 782, 799, and 815 stores, respectively. In the same period it had paid Kohl a salary of $2,000 a week (R. 18). For a long time the respondent had invested its surplus profits in stocks and bonds in order to obtain a greater return therefrom than would have been possible from bank deposits and with the thought in mind of realizing cash thereon for the purpose of expanding its chain of grocery stores at any time desired. The only dividends it had paid up to the end of the taxable year were two of $25,000 each, one in 1917 and one in 1918. On the other hand, the respondent had advanced $394,100 to Kohl up to January 26, 1925, on notes bearing interest, although no interest had ever been charged or paid thereon; and thereafter it made further loans to him on notes bearing no interest, so that at the end of the taxable year it had loaned him $610,000.

In that year the respondent loaned Kohl $140,000, of which $40,000 was to enable him to acquire a house in Florida, and $100,000 to make a personal charitable contribution. A part of the loans was canceled in subsequent years by dividends declared after the end of the taxable year, a balance of $424,000 remaining unpaid as late as April 23, 1936 (R. 19–20). The respondent's balance sheet for the fiscal years ended January 31, 1928, to January 31, 1931, inclusive, shows as follows (R. 20):[1]

	Fiscal years ended			
	1/31/28	1/31/29	1/31/30	1/31/31
ASSETS				
Cash	$659,734.40	$890,397.59	$1,332,332.28	$1,405,961.04
Notes receivable	424,100.00	460,000.00	470,000.00	610,000.00
Accounts receivable	1,888.82	3,975.19	26,816.37	3,220.85
Inventories	2,615,057.67	2,917,716.55	3,189,396.72	2,812,939.16
Mortgage	59,000.00	59,000.00	59,000.00	59,000.00
Bonds	256,114.76	96,820.30	59,435.00	313,391.27
Stocks	2,169,687.62	2,318,074.13	2,720,283.07	2,676,061.47
Other	6,236.39	7,425.08	10,150.89	20,686.18
Deferred	33,338.64	25,685.23	31,875.79	29,687.74
Permanent	1,542,129.60	1,501,193.83	1,345,976.63	1,177,489.43
Total	7,767,287.90	8,280,287.90	9,245,266.75	9,108,437.14
LIABILITIES				
Notes payable and mortgages	1,008,750.00	700,000.00	790,000.00	----------
Accounts payable	258,889,61	270,318.54	371,121.96	269,140.49
Accrued	7,742.15	7,385.56	19,757.11	7,411.70
Reserve income tax	93,933.45	72,035.56	52,592.97	51,330.42
Reserve insurance	417,797.77	491,032.34	565,970.45	641,588.99
Capital stock and surplus	5,980,174.92	6,739,515.90	7,445,824.26	8,138,965.54
Total	7,767,287.90	8,280,287.90	9,245,266.75	9,108,437.14

The fair market value of the securities owned by the respondent on January 31, 1931, was $2,125,-

[1] The tabulation is a part of the respondent's balance sheet, 1907 to 1935 (Exhibit 6, R. 136X137).

434.50, as against the cost of $2,989,452.74, a difference of $864,018.24.

In conclusion, the Board found that, during the fiscal year ended January 31, 1931, the respondent was availed of for the interdicted purpose.

The court below, in an opinion written by Judge Buffington, Judge Biggs dissenting, reversed the Board's decision, on the ground that the Board had relied solely on the report of a revenue agent and other information furnished to the Commissioner; that it had failed to pass on what the court considered the uncontradicted proof of the respondent; and that this assertedly uncontradicted testimony showed that the business needed the surplus which respondent maintained (R. 172–180). "Without entering into further details," the court below held that "the Tax Board had before it no proof, substantial or otherwise, to support its imposition of this penal tax" (R. 178).

SPECIFICATION OF ERRORS TO BE URGED

The Circuit Court of Appeals erred—

1. In finding, concluding, and holding that the Board of Tax Appeals had failed to pass upon what the court considered to be the uncontradicted proofs made by the respondent, and that, when this was called to the Board's attention, it had failed to call witnesses but had based its finding solely upon a report made to the Commissioner by a revenue agent of an *ex parte* investigation made by him, which is not in evidence, and upon certain subse-

quent information furnished the Commissioner, the nature of which is not disclosed by the evidence.

2. In failing to remand the proceeding to the Board for a rehearing, if it is true that the Board was guilty of such an arbitrary disposition of the issues.

3. In usurping the power of administrative decision by finding the facts from conflicting evidence, determining the issue itself, and substituting such determination for that of the administrative body.

4. In rejecting a finding of fact made by the Board that, in the fiscal year ended January 31, 1931, the respondent's gains and profits were permitted to accumulate beyond the reasonable needs of its business, where it does not appear that the evidence, with every reasonable inference that may be drawn therefrom in the petitioner's favor, is insufficient to sustain such finding, and in making its own contrary finding upon the basis of testimony of certain facts which, standing alone, would support such contrary finding; and, in so doing, failing to consider evidence of an array of facts, which, together with proper inferences to be drawn therefrom, discounts the testimony which the court relied upon and supports the finding of the Board.

5. In rejecting a finding of fact made by the Board that the respondent has failed to overcome the statutory presumption arising from the fact that it had permitted its gains and profits to accumulate beyond the reasonable needs of its busi-

ness, where it does not appear that the evidence, with every reasonable inference that may be drawn therefrom in favor of the petitioner, is insufficient to sustain such finding.

6. In rejecting a finding of fact made by the Board that the respondent was availed of for the interdicted purpose, where it does not appear that the evidence, with every reasonable inference that may be drawn therefrom in the petitioner's favor, is insufficient to sustain it.

7. In entering a judgment the effect of which is either to expunge the deficiency determined by the Board or to require the Board to do so.

8. In reversing the Board's order of redetermination of the deficiency in the tax of $477,360.68.

SUMMARY OF ARGUMENT

Section 104 of the Revenue Act of 1928 imposes an additional tax of 50 per cent upon corporations formed or availed of for the purpose of permitting its shareholders to escape surtaxes, and makes the accumulation of earnings and profits beyond the reasonable needs of the business prima facie evidence of such purpose. From the evidence before it the Board found that the respondent's accumulations in the taxable year ended January 31, 1931, were beyond such needs; that the evidence did not overcome the attendant presumption, and that the corporation was availed of in that year for the interdicted purpose.

Instead of reviewing all of the evidence to determine whether, with inferences favorable to the

petitioner, it supported the Board's decision, the court below proceeded first to a destructive analysis of the Board's decision and then to an independent determination of the issue. In both respects it committed reversible error.

The error involved in the analysis of the Board's decision is important because it is in large part due thereto that the court below disregarded its true basis. It is abundantly clear that, while the Board may have arranged its opinion "inartistically" (cf. R. 180), it did determine for itself as a fact and upon the evidence before it, that the gains and profits had been accumulated beyond reasonable business needs; and that it then determined from all the evidence that the attendant presumption had not been refuted and that the corporation was availed of for the interdicted purpose.

In proceeding itself to find the facts from conflicting evidence, contrary to the findings of the Board, the court below culled from the evidence certain facts which, standing alone, would have supported a contrary finding. In so doing, the court failed to consider an array of facts which not only discounted the testimony the court relied upon but amply justified the Board's findings. The facts ignored in the majority opinion below clearly indicate that a sizable portion of the respondent's profits for the taxable year in question could have been declared as dividends without curbing in the

slightest the reasonable needs of its business. Furthermore, these facts effectively dispose of the various reasons given by the respondent in support of its contention that it did not entertain such purpose.

The respondent's sole stockholder, Kohl, used it as his "pocketbook." The evidence clearly indicates that disbursements were made to him upon the basis of his own needs and not upon the basis of what the respondent could reasonably have disbursed to him.

The conclusion is inescapable that, in its review of the Board's decision, the court below has departed from the usual and accepted course of judicial proceedings, and that the Board's decision should have been affirmed because it was supported by the evidence.

ARGUMENT

THE COURT BELOW DEPARTED FROM THE ACCEPTED AND NORMAL COURSE OF JUDICIAL PROCEEDINGS IN ITS DECISION AND OPINION CONCLUDING THAT THERE WAS NO EVIDENCE TO SUSTAIN THE DETERMINATION OF THE BOARD OF TAX APPEALS THAT THE RESPONDENT WAS AVAILED OF DURING THE TAXABLE YEAR FOR THE PURPOSE OF DETERMINING THE IMPOSITION OF THE TAX

(a) *The question before the court below and how it arose*

Subdivision (a) of Section 104 of the Revenue Act of 1928 (Appendix, *infra*, p. 28) imposes an additional tax of 50 per cent of net income upon

any corporation that is formed or availed of for the purpose of preventing the imposition of the surtax upon its shareholders through the medium of permitting its gains and profits to accumulate instead of being divided or distributed. Article 541 of Treasury Regulations 74, promulgated under that Act (Appendix, *infra*, p. 29), explains that the section was designed to discourage the formation or use of a corporation for the interdicted purpose.[2] Subdivision (b) of said section (Appendix, *infra*, p. 28) provides that the fact that any corporation is a mere holding or investment company, or that its gains or profits are permitted to accumulate beyond the reasonable needs of the business, shall be prima facie evidence of a purpose to escape the

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[2] See also S. Rep. No. 617, 65th Cong., 3d Sess., p. 5; S. Rep. No. 275, 67th Cong., 1st Sess., pp. 16–17; *A. D. Saenger, Inc.* v. *Commissioner*, 84 F. (2d) 23, 24 (C. C. A. 5th), certiorari denied, 299 U. S. 577. The statute is designed reasonably to carry out the purpose of Congress to prevent tax avoidance. *Almours Securities* v. *Commissioner*, 91 F. (2d) 427, 429 (C. C. A. 5th), certiorari denied January 10, 1938; *Williams Inv. Co.* v. *United States*, 3 F. Supp. 225, 232 (C. Cls.). Compare *Helvering* v. *Mitchell*, No. 324, October Term, 1937, decided March 7, 1938, and particularly note 15 to the opinion of the Court. As such, it must be reasonably construed to effectuate such purpose. *Taylor et al* v. *United States*, 3 How. 197; *United States* v. *Stowell*, 133 U. S. 1; *United States* v. *Hodson*, 10 Wall. 395; *United States* v. *Graf Distilling Co.*, 208 U. S. 198; *Farmers' Loan & Trust Co.* v. *Bowers*, 68 F. (2d) 916 (C. C. A. 2d), certiorari denied, 293 U. S. 565, 296 U. S. 649, and 299 U. S. 582.

tax;[3] and Article 543 declares the accumulation to be unreasonable "if it is not required for the purposes of the business, *considering all the circumstances of the case.*" [Italics supplied.]

The Board found, upon the evidence adduced, that the respondent's "accumulation of earnings was far in excess of the 'reasonable needs' of the corporate business;" furthermore, that the evidence did not rebut the prima facie presumption created by the statute that the accumulation of earnings beyond the "reasonable needs of the business" was for the purpose of preventing the imposition of the surtax upon its sole stockholder (R. 23); and that upon the evidence before it, the Board had made the finding (R. 21) that the respondent was "availed of" for the interdicted purpose, during the fiscal year ended January 31, 1931. Whether the respondent permitted its gains and profits to accumulate beyond the reasonable needs of its business, and whether it was availed of for the purpose of preventing the imposition of a surtax upon its shareholders are clearly questions of fact, upon which the Board's findings are conclusive if sup-

[3] As the Circuit Court of Appeals for the Second Circuit pointed out in *United Business Corporation* v. *Commissioner*, 62 F. (2d) 754, 755, certiorari denied, 290 U. S. 635, the presumption is necessary as the purpose is difficult of establishment, unless the officers of the corporation unexpectedly disclose a scheme to avoid taxes. As Judge Learned Hand in that case said the corporation is thereby compelled to show its hand in circumstances justifying the presumption.

ported by the evidence. *United Business Corporation* v. *Commissioner,* 62 F. (2d) 754 (C. C. A. 2d), certiorari denied, 290 U. S. 635; *United States* v. *R. C. Tway Coal Sales Co.,* 75 F. (2d) 336 (C. C. A. 6th); *A. D. Saenger, Inc.,* v. *Commissioner,* 84 F. (2d) 23 (C. C. A. 5th); certiorari denied, 299 U. S. 577; *R. & L., Inc.,* v. *Commissioner,* 84 F. (2d) 721 (C. C. A. 5th); *Commissioner* v. *Fisher & Fisher,* 84 F. (2d) 996 (C. C. A. 2d); *Commissioner* v. *Cecil B. De Mille Productions,* 90 F. (2d) 12 (C. C. A. 9th), certiorari denied, October 11, 1937; *Almours Securities* v. *Commissioner,* 91 F. (2d) 427 (C. C. A. 5th), certiorari denied, January 10, 1938. Thus the only question before the court below was whether the evidence, with every reasonable inference to be drawn therefrom in the petitioner's favor, supported the findings and judgment of the Board.

(b) *The disposition of the question by the court below*

What the court below should in these circumstances have done, but did not do, was to review all of the evidence in the case to determine whether there was any evidence to support the Board's findings and decision. Instead, it proceeded first to a destructive analysis of the Board's decision and then to an independent determination of the issue. In both respects, we think, the court committed error.

Specifically, with respect to its analysis of the Board's decision, the court wrongfully charged the

Board with having neglected to consider what the court regarded as the uncontradicted proofs given by the respondent;[4] with having based its action solely on the revenue agent's report and other information furnished to the Commissioner, none of which was in evidence; with having failed itself to determine whether the profits were accumulated beyond the reasonable needs of the business, or to make a finding to that effect;[5] with having failed

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[4] It cannot be said that the evidence recited by the court was truly uncontradicted. While the Government did not introduce opposing opinion evidence, this was not necessary. The respondent's evidence carried its own refutation; it supported the affirmative. Besides, the development in the record of the actual status of respondent's business consists largely of joint exhibits. Several of the exhibits formally introduced by respondent were prepared by the Government (R. 56) and were offered at the Government's request (R. 57, 59) or with its prior approval (R. 48, 53, 56) and in a joint effort to facilitate the conduct of the trial.

[5] Since the court stated that the "basic thing was for the Board to itself determine whether the 'profits are permitted to accumulate beyond the reasonable needs of the business,'" and then observed that "the Board made no such finding as the Act requires" (R. 177), apparently the court felt that the finding omitted by the Board was that pertaining to accumulation beyond the reasonable needs of the business. But the court then stated that the Board had failed to make the required finding "notwithstanding its attention was called thereto in the dissenting opinion" (R. 177). Examination of the paragraph quoted from Member Mellott's dissent (R. 25) discloses that he had reference to the finding of the ultimate purpose to escape surtaxes rather than the intermediate fact of accumulation beyond the reasonable needs of the business. Moreover, he was merely calling attention to the Commissioner's failure explicitly to make this finding, and by no means implied that the Board did not make such a finding.

to made the finding required by the statute, though the dissenting members called attention to this, and instead construing the revenue agent's report and the other information furnished the Commissioner as *prima facie* evidence of a purpose to prevent the imposition of a surtax upon respondent's stockholder; and with acting on this allegedly foundationless *prima facies* in drawing the conclusion that "We [the Board] are also of the opinion that the evidence of record does not rebut the prima facie presumption created by the statute" (R. 23). The error involved in this analysis is important because it was in large part due thereto that the court below disregarded the true basis of the Board's decision and much of the evidence introduced before it and considered by it.

Now, if it had been true that the Board was guilty of such an arbitrary disposition of the issues, it was clearly the duty of the court to remand the proceeding for rehearing, so that the Board could consider the evidence it had allegedly neglected to consider on the first hearing. But, instead, and while ostensibly reviewing the facts to determine whether there was any evidence to sustain the Board's findings of an accumulation beyond the reasonable needs of the business and of the interdicted purpose, the court below proceeded itself to

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But, whichever finding it was that the court thought had not been made by the Board, it is apparent that it made both findings upon its own inferences from evidence introduced before it. See *infra*, pp. 16–18.

find the facts from conflicting testimony and to determine the issues contrary to the findings of the Board. Moreover, in so doing, it culled from the evidence certain facts, which, standing alone, would support such a contrary finding. Thus it dwelt at great length upon the history of the respondent's "cash and carry" business, as testified to by Kohl, and his testimony and that of other witnesses called by the taxpayer to the effect that in their opinion the accumulations were reasonably necessary (1) in the expansion of its grocery business, (2) in the conduct of that business, and (3) because of the depreciation in the value of its investments during the depression. And, by the same token, it failed to consider an array of facts (see *infra*, pp. 18 to 25), which, together with inferences to be drawn therefrom, not only discounted the testimony the court relied upon, but amply justified the findings of the Board. In short, the court below proceeded with the case as though the findings and decision had been in the *respondent's* favor, selecting from the evidence and discussing such facts as would have supported such a judgment.

The signal objection to such review is that the court thereby disposed of the case in accordance with its own inferences from the evidence. It tried the case *de novo,* substituting its own judgment for that of the administrative body and thus usurped the power of administrative decision. It is only the trier of the facts who may choose between con-

flicting inferences which arise from the facts. "It is the function of the Board to weigh the evidence and declare the result." *Elmhurst Cemetery Co.* v. *Commissioner,* 300 U. S. 37, 40. Clearly the court below has disregarded the injunction in *Hulburd* v. *Commissioner,* 296 U. S. 300, 306, that it is "without power to choose between conflicting inferences unless only one was possible, or to try the case *de novo.*" Compare *Helvering* v. *Rankin,* 295 U. S. 123.

In fact, however, the court below misinterpreted the basis of the Board's decision.

(c) *The actual basis of the Board's decision*

Although the Board did set out so much of the Commissioner's deficiency letter as gave his reasons for his determination—namely, that, upon the basis of information furnished that office he had approved the conclusion of the revenue agent that there existed an accumulation of profits beyond the reasonable needs of the business—the Board nowhere indicated that it was relying on the Commissioner's finding, or on the revenue agent's report, or on the other information furnished the Bureau therein referred to; and it certainly negatived any suggestion that the deficiency letter, or the evidentiary matter therein mentioned, constituted the basis of its decision. It is abundantly clear that, though the Board may have arranged its opinion "inartistically" (Cf. R. 180), it did determine for itself and find as a fact, and upon the evi-

dence before it, that the gains and profits had been accumulated beyond the reasonable business needs (R. 22–23), and that it then examined the other evidence and from all the evidence determined that the statutory presumption of the purpose to avoid surtaxes had not been rebutted—indeed that it had been corroborated (R. 23–24)—concluding with an express finding of the interdicted purpose (R. 24).

The Board concisely summed up the evidence on which it primarily relied in reaching its conclusion that the accumulation of profits was beyond the reasonable needs of the business. It adverted to several factors in the evidence—namely, (a) that since prior to 1922, when the respondent began to invest in stocks and bonds, its holdings of securities had greatly increased, and that up to 1929 there had also been a very large increase in the market value of the securities acquired; (b) that, since 1929, the respondent had not greatly expanded its grocery business; (c) that its large profits had not been distributed as dividends but had been mostly invested in securities; (d) that the respondent's balance sheets for the beginning and the end of the taxable year showed current assets far in excess of actual liabilities, cash on hand alone being far in excess of actual liabilities; and (e) that its actual surplus at January 31, 1931, was $7,938,965.54. And, finally, the Board disposed of the taxpayer's contention that the surplus was of benefit to it in obtaining credit at banks and in enabling it to purchase merchandise at low prices and

in obtaining lower rates of interest because of its large investment in stocks and bonds (R. 22–23).

Only then did the Board turn to a consideration of whether the evidence rebutted the statutory presumption attending its finding that the accumulations were beyond the respondent's reasonable business needs. The Board, concluding that it did not, pointed out that the evidence showed that Kohl personally needed some of the profits in that year, had prior thereto borrowed $470,000 from the company without paying interest, and had increased his borrowings by an additional $140,000 in the taxable year with the result that there was an escape of the surtax upon (at least) that amount (R. 23–24).

(d) *The facts which the court below overlooked or disregarded*

In addition to its disregard of the Board's findings, the court overlooked or disregarded an array of facts and circumstances which, together with proper inferences to be drawn therefrom, not only discount the testimony it relied upon, but amply justify the findings of the Board.

Respondent's profits for the taxable year were shown on its books (after deducting Kohl's salary of $104,000 and its income taxes of $103,616.60) as $682,550.38.[6] The facts about to be discussed in-

[6] The net taxable income, upon which the tax was based, as shown in Exhibit A, attached to the respondent's petition filed with the Board, was $954,645.62. The correctness of

dicate clearly that a sizeable portion of this profit could have been declared as dividends without curbing in the slightest the reasonable needs of the business. Furthermore, the facts effectively dispose of each of the reasons given by the respondent in support of its contention that it did not entertain the purpose to avoid surtaxes, namely, (1) that it needed the accumulations to acquire new stores; (2) that it needed them in its grocery business; and (3) that they were needed because of the depreciation in the value of its securities and other property.

(1) The accumulations were not needed to acquire new stores. Respondent's policy was merely to rent stores, not to purchase the real estate on which they were located (R. 68). Only $5,000 was needed to acquire and finance each new store (R. 68–69). During the taxable year respondent paid off all its bank loans, $790,000, and decreased its accounts payable by more than $100,000 and its accrued expenses by more than $12,000 (Exhibit 6, R. 136–137). Yet it had left a working capital of $4,500,000, according to its witness, Field (R. 86); and, though his mode of estimate is not set out, his

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this figure is not in controversy. The Board, in its finding (R. 18), used the book figure of $786,466.98, which was apparently derived from the books, and may represent a slight arithmetical error of $300 in adding $682,550.38 and $103,616.60, the correct sum of which is $786,166.98.

figure is, if erroneous at all, too small.[7] Since respondent had $1,405,961.04 cash in the bank, and current liabilities of only $276,552.19 (R. 137), it is obvious that it could have paid its current liabilities

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[7] Field stated that the working capital at the end of 1930 was $3,700,000-odd, and at the end of January 1931 was $4,500,000 (R. 86).

The normal signification of "net working capital" is the excess of current assets over current liabilities. Paton, *Accountants' Handbook* (2d Ed., 1934), pp. 19, 153; Kester, *Principles of Accounting* (3d Revised Ed.), Vol. 1, p. 29. "Current assets" include cash and other assets, such as accounts receivable and inventory which will presumably be converted into cash in the near future through the regular operations of the business. Finney, *Introduction to Principles of Accounting* (1932), p. 167; Kester, *Principles of Accounting*, *supra*, pp. 28–29.

The following computation of working capital is based on Exhibit 6, R. 137:

	Year ending	
	1/31/30	1/31/31
Current Assets:		
Cash	$1,332,332.28	$1,405,961.04
Notes Receivable	470,000.00	610,000.00
Accounts Receivable	26,816.37	3,220.85
Merchandise Inventory	3,189,396.72	2,812,939.16
Mortgage	59,000.00	59,000.00
Bonds and stocks	2,779,718.07	2,989,452.74
Total current assets	7,857,263.44	7,880,573.79
Current Liabilities:		
Notes Payable	750,000.00	
Accounts Payable	371,121.96	269,140.49
Accrued Expenses	59,757.11	7,411.70
Total current liabilities	1,180,879.07	276,552.19
Working capital	6,676,384.37	7,604,021.60

Even if account is taken of the depreciation in the value of the stocks and bonds, and their book value is replaced by

in full in cash, could in addition have acquired and financed 100 additional stores with cash, and still have had left a working capital of at least $3,723,447.81, of which $629,408.85 would have been in cash.

(2) The accumulations were not needed in the respondent's grocery business. The testimony considered by the court with respect to this point is even more vague than the testimony regarding expansion. The court (R. 175) quoted Mr. Field's references to "panicky conditions," to the company's turnover, to the necessity for "a considerable working capital and a surplus to meet any additional losses they might encounter" (apparently on inventory).[8]

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fair market value (which, according to respondent's own estimate (R. 61–62, 146), was $2,859,217.25 as of January 31, 1930, and $2,125,434.50 as of January 31, 1931), the working capital is still seen to be $6,755,883.55 on January 31, 1930, and $6,740,003.86 on January 31, 1931, much higher than Field's figures.

Field may have obtained these figures by eliminating all consideration of stocks, bonds, and mortgages, for, upon that hypothesis, the working capital figures become $3,837,666.30 on January 31, 1930, and $4,555,568.86 as of January 31, 1931. There seems to be no warrant, however, for excluding from "current assets" an item of investments which respondent claims to have acquired merely in order to have on hand an equivalent of cash.

[8] It is true that Kohl (R. 72), as well as Miss Mullins, the treasurer (R. 79), testified that the accumulations were needed to finance purchases, pay rent, etc., and that at times the company was forced to borrow money to do so. But neither gave any further particulars, and it is not to be assumed that the corporation needed its $8,000,000 accumula-

In discussing respondent's working capital needs, it may first be noted that its "cash and carry" system rendered unnecessary as large a working capital as would be needed by a concern extending credit. Thus, the apparently formidable item of respondent's purchases, amounting to about $20,000,000 for the year in question (R. 141), must be considered in light of the fact that respondent turned its stock over *on a cash basis* from 6 to 8 times a year (R. 86). In this way, it received some $25,000,000 from its merchandise sales (R. 7).

It is apparent that respondent's working capital far exceeded its reasonable needs. Field's minimum estimate of respondent's working capital of January 31, 1931, as $4,500,000 (which at least takes into consideration depreciation of both merchandise[9] and securities, if it does not actually

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tion for these purposes, or that the shortage in cash did not occur because at the time the cash normally available for these purposes had been or was being used in the purchase of securities. In the circumstances, the purport and effect of this testimony was for the trier of the fact.

[9] The difference between inventory for January 31, 1930, and January 31, 1931, cannot be regarded as depreciation. Kohl testified that everything declined in value in 1930 and the petitioner's witness, Anna Mullins, the treasurer of the company, testified that there was a "decline" in the petitioner's merchandise inventories from $200,000 to $250,000. If we consider the fact that there was a complete turnover in its capital 6 or 8 times in that year, involving purchases of merchandise in excess of $19,000,000, the inference seems inescapable that much of the decline referred to resulted from new purchases in the course of the year at lower prices rather than from a decline in the value of goods that had been purchased in prior years at higher prices.

eliminate them entirely, see *supra*, note 7) bears a ratio to current liabilities of 15 to 1, while the ratio of cash to such liabilities was 5 to 1. As to Field's fears with respect to additional losses on inventory, if the merchandise had declined in value by half—some $1,400,000—working capital would still have been more than ten times as large as current liabilities.

The court below did not rest content with the explanations of respondent's witnesses. It added a word of its own and regarded the accumulations as respondent's bulwark against fires, earthquakes, floods, war, strikes, boycotts, and a host of unforeseen calamities. None of the witnesses stated that the profits were accumulated for these purposes, and none of them even suggested that earthquakes, floods, etc., were probable in New Jersey, or expensive to insure against, or that in 1930 the respondent's labor relations were unsatisfactory. Indeed, with respect to the only fears that the company deemed real and reasonable (fire, burglary, etc.), it had started its own self-insurance reserves (R. 60, 144), which it carried as a liability on its balance sheets (R. 137).

(3) The accumulations were not needed because of the depreciation in value of the securities or inventories. Computations with respect to working capital making allowance for depreciation still

show an unreasonable accumulation.[10] See pp. 19–23, and note 7, *supra*.

Moreover, on cross-examination, both Kohl and the company treasurer explicitly testified that neither an increase nor decrease of the petitioner's assets had anything to do, practically speaking, with the declaration of dividends (R. 74, 83, 84). Mr. Field and Mr. Ferguson, bankers called as witnesses by respondent, both testified that the company could have declared a dividend in 1930 of

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[10] The respondent offered Exhibit 15 (R. 146) for the purpose of showing depreciation in the market value of its securities as of January 31, 1931, to be $943,517.42 (R. 61–62). Nevertheless, in the court below, as also in its brief in opposition (pp. 7–8), it argued that to this should be added the sum of $1,068,622, representing the market value of six bank stocks as shown on Exhibit 15, for which the witness Field said there was, in fact, no sale. Thus respondent seeks to draw inferences favorable to it even upon contradictory evidence introduced by it. Furthermore, with respect to one of the items sought to be eliminated, namely, $38,600, the market value of the stock of the First National Bank of Jersey City, it is to be noted that 300 shares of this were purchased by it in the taxable year in question for $23,400. (See the fourth sheet of said Exhibit 15, 3rd item in column headed "Purchases after 1/31/30.")

It is further to be noted that the respondent also contended that there should be added $376,457.56, which represents merely the difference between the opening and closing inventories for the year in question. Clearly there is no justification for that. Furthermore, since these inventories were taken at cost or market, whichever was lower, the closing inventory already reflected any loss in value that the goods inventoried may have sustained at the end of the taxable period. (See Exhibit 6, R. 136; also note 9, p. 22, *supra*.)

$100,000, without impairing its business (R. 90, 94). Indeed Field testified (R. 90) that respondent's credit was "as good today as it was ten years ago" though in the five years subsequent to the taxable year in question the petitioner had paid $800,000 in dividends out of a much diminished net profit of $1,341,382.42 (R. 133).[11]

(e) *The climactic fact that the sole stockholder used the respondent corporation as his "pocketbook"*

The facts discussed above support, we submit, if indeed they do not compel, the finding that the gains and profits of respondent were permitted to accumulate beyond the reasonable needs of the business. That the purpose of this accumulation was the avoidance of surtaxes on the sole stockholder, Kohl, is borne out by the fact that Kohl used the corporation as his "pocketbook."

[11] See the following table derived from Exhibit 4 (R. 133):

Year ending January 31	Net profits after deducting Kohl's salary & Inc. taxes	Dividends declared	Left for accumulation
1931—1/31/32	$525,947.67	$100,000.00	$425,947.67
1932—1/31/33	132,991.35	100,000.00	32,991.35
1933—1/31/34	111,211.91	100,000.00	11,211.91
1934—1/31/35	368,685.50	300,000.00	68,685.50
1935—1/31/36	202,545.99	200,000.00	2,545.99
Total	1,341,382.42	800,000.00	541,382.42

The only dividends paid to Kohl by respondent up to January 31, 1931, were a dividend of $25,000 in 1917, and one of a like amount in 1918 (R. 19, 84; Ex. 4, R. 133). Kohl followed the policy of "keeping all of my profits in the business, except what were necessary for my bare living expenses" (R. 66). But by January 31, 1930, he had borrowed from respondent $470,000, partly on demand notes bearing no interest and partly on notes on which no interest has ever been charged or paid (R. 19). During the taxable year it loaned him an additional $140,000, on notes bearing no interest, in order that he might acquire a house in Florida and make a charitable contribution (R. 20, 24). These loans, taken together with the fact that since 1925 respondent has paid Kohl a salary of over $100,000 a year, deductible on its income tax return, indicate that disbursements were made to him upon the basis of his needs and not upon the basis of what the respondent could reasonably have disbursed (cf. R. 66).

CONCLUSION

The conclusion appears inescapable that in its review and consequent reversal of the decision of the Board in this case, the court below has departed from the accepted and usual course of judicial proceedings. And, since the Board's findings and decision are supported by evidence, it is respectfully

submitted that the judgment of the court below should be reversed with direction to dismiss the respondent's petition for review.

ROBERT H. JACKSON,
Solicitor General.
JAMES W. MORRIS,
Assistant Attorney General.
SEWALL KEY,
CARLTON FOX,
Special Assistants to the Attorney General.

MARCH 1938.

APPENDIX

Revenue Act of 1928, c. 852, 45 Stat. 791:

SEC. 104. ACCUMULATION OF SURPLUS TO EVADE SURTAXES.

(a) If any corporation, however created or organized, is formed or availed of for the purpose of preventing the imposition of the surtax upon its shareholders through the medium of permitting its gains and profits to accumulate instead of being divided or distributed, there shall be levied, collected, and paid for each taxable year upon the net income of such corporation a tax equal to 50 per centum of the amount thereof, which shall be in addition to the tax imposed by section 13 and shall be computed, collected, and paid upon the same basis and in the same manner, and subject to the same provisions of law, including penalties, as that tax.

(b) The fact that any corporation is a mere holding or investment company, or that the gains or profits are permitted to accumulate beyond the reasonable needs of the business, shall be prima facie evidence of a purpose to escape the surtax.

(c) As used in this section the term "net income" means the net income as defined in section 21, increased by the sum of the amount of the dividend deduction allowed under section 23 (p) and the amount of the interest on obligations of the United States issued after September 1, 1917, which would be subject to tax in whole or in part in the hands of an individual owner.

(d) The tax imposed by this section shall not apply if all the shareholders of the corporation include (at the time of filing their

returns) in their gross income their entire distributive shares, whether distributed or not, of the net income of the corporation for such year. Any amount so included in the gross income of a shareholder shall be treated as a dividend received. Any subsequent distribution made by the corporation out of the earnings or profits for such taxable year shall, if distributed to any shareholder who has so included in his gross income his distributive share, be exempt from tax in the amount of the share so included.

Treasury Regulations 74, promulgated under the Revenue Act of 1928:

ART. 541. *Taxation of corporation utilized for evasion of surtax.*—Section 104 is designed to discourage the formation or use of a corporation for the purpose of preventing the imposition of surtaxes upon its shareholders, through the device of permitting its gains and profits to accumulate instead of being distributed. If a domestic or foreign corporation is so formed or availed of, it is subject to a tax at the rate of 50 per cent upon its net income in addition to the tax imposed by section 13. However, the additional tax at the rate of 50 per cent does not apply for 1928 or any subsequent taxable year if all the shareholders of the corporation include (at the time of filing their returns) in their gross income their entire distributive share, whether distributed or not, of the net income of the corporation for such year or years. Any amount so included in the gross income of a shareholder shall be treated as a dividend received, and any subsequent distribution made by the corporation out of the earnings or profits for such taxable years shall, if distributed to any shareholder who has so included in his gross

income his distributive share, be exempt from tax in the amount of the share so included.

ART. 542. *Purpose to escape surtax.*—Prima facie evidence of a purpose to escape the surtax exists where a corporation is a mere investment company, where a corporation has practically no business except holding stocks, securities, or other property and collecting the income therefrom or investing therein, or where a corporation other than a mere holding or investment company permits its gains and profits to accumulate beyond the reasonable needs of the business. The statutory presumption that a mere holding or investment company is subject to the additional tax imposed by section 104 may be overcome if the corporation can show, either by reason of the fact that it distributed a large portion of its earnings for the year in question, or that its stock was held not by the members of a family or of a small group but by a large number of persons and in comparatively small blocks, or by other evidence, that it was not availed of for the purpose of preventing the imposition of the surtax upon its shareholders.

The business of a corporation is not merely that which it has previously carried on, but includes in general any line of business which it may legitimately undertake. However, a radical change of business when a considerable surplus has been accumulated may afford evidence of a purpose to escape the surtax. When one corporation owns the stock of another corporation in the same or a related line of business and in effect operates the other corporation, the business of the latter may be considered in substance the business of the first corporation. Gains and profits of the first corporation put into the

second through the purchase of stock or otherwise may therefore, if a subsidiary relationship is established, constitute employment of the income in its own business. To establish that the business of one corporation can be regarded as including the business of another it is ordinarily essential that the first corporation own substantially all of the stock of the second. Investment by a corporation of its income in stock and securities of another corporation is not without anything further to be regarded as employment of the income in its business.

ART. 543. *Unreasonable accumulation of profits.*—An accumulation of gains and profits is unreasonable if it is not required for the purposes of the business, considering all the circumstances of the case. It is not intended, however, to prevent reasonable accumulations of surplus for the needs of the business. No attempt can be made to enumerate all the ways in which gains and profits of a corporation may be accumulated for the reasonable needs of the business. Distributions made by a corporation shortly after the close of its taxable year shall be taken into consideration in determining the reasonableness of the amount of earnings and profits of the corporation retained by it for such year. Undistributed income is properly accumulated if invested in increased inventories or additions to plant reasonably needed by the business. It is properly accumulated if retained for working capital required by the business or in accordance with contract obligations placed to the credit of a sinking fund for the purpose of retiring bonds issued by the corporation. In the case of a banking institution the business of which is to receive and loan money,

using capital, surplus, and deposits for that purpose, undistributed income actually represented by loans or reasonably retained for future loans is not accumulated beyond the reasonable needs of the business. The nature of the investment of gains and profits is immaterial if they are not in fact needed in the business. It is an unreasonable accumulation of gains and profits by corporations with the purpose of enabling their shareholders to escape surtaxes on such gains and profits which subjects such corporations to the additional tax imposed by section 104. Among other things, the financial condition of the corporation at the close of the taxable year and the manner in which its funds are invested at that date, determine the reasonableness of the accumulations.

For the purpose of section 104 the term "net income" means the net income of the corporation as defined in section 21 increased by the sum of (1) the amount received as dividends and allowed as a deduction by section 23 (p), plus (2) the amount of interest on obligations of the United States issued after September 1, 1917, which would be subject to tax in whole or in part in the hands of an individual owner. The Commissioner, or any collector upon direction from the Commissioner, may require any corporation to furnish a statement of its accumulated gains and profits, the name and address of, and number of shares held by, each of its shareholders, and the amounts that would be payable to each, if the income of the corporation were distributed. (See section 149 (c).)

U. S. GOVERNMENT PRINTING OFFICE: 1939

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In the Supreme Court of the United States

OCTOBER TERM, 1937

No. 723

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

NATIONAL GROCERY COMPANY

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT

REPLY BRIEF FOR THE PETITIONER

SECTION 104 OF THE REVENUE ACT OF 1928 IS A VALID EXERCISE OF LEGISLATIVE POWER

The respondent contends (Br. 40–61) that Section 104 is not within the competence of Congress, with the result that Congress is impotent to deal with so flagrant a purpose to avoid the imposition of surtaxes as is presented in the case at bar. Its contention is fivefold: First, that the tax in question is not a tax on income, but a direct tax on a purpose or state of mind (Br. 40–45); secondly, that it is not an income tax within the meaning of the Sixteenth Amendment, but a penalty designed

to force corporations to distribute their earnings, in order to create a basis for taxation of such distributions in the hands of their stockholders, and hence merely an attempt "to control and regulate the dividend policy of domestic corporations" (Br. 45–55); thirdly, that the Act violates the Tenth Amendment, but only so far as it applies to operating companies, it being conceded that it is valid as to holding companies *formed* for such purpose (Br. 55–61); fourthly, that the tax deprives the respondent of its property without due process of law in contravention of the Fifth Amendment, in that the statutory classification furnishes no definite and certain criteria for ascertaining when the incidence of the tax will fall upon operating companies (Br. 62–65); and, lastly, that it involves an unconstitutional delegation of legislative power.

Each of these contentions has been disposed of by lower appellate courts. *United Business Corp.* v. *Commissioner,* 62 F. (2d) 754 (C. C. A. 2d), certiorari denied 290 U. S. 635; *Williams Inv. Co.* v. *United States,* 3 F. Supp. 225 (C. Cls.); *A. D. Saenger, Inc.* v. *Commissioner,* 84 F. (2d) 23 (C. C. A. 5th), certiorari denied, 299 U. S. 577; *Keck Inv. Co.* v. *Commissioner,* 77 F. (2d) 244 (C. C. A. 9th), certiorari denied, 296 U. S. 633; *Almours Securities* v. *Commissioner,* 91 F. (2d) 427 (C. C. A. 5th), certiorari denied, January 10, 1938. Following the decision in the *Williams Inv. Co.* case, the Court

denied certiorari in the *United Business Corp.* case, even though the Government did not oppose the granting of the writ, the decision being the first to dispose of the constitutional objections. In the *United Business Corp.*, the *Keck*, and the *Almours* cases, the taxpayers pressed upon the Court every possible objection to the validity of the statute. And, in the *Almours* case, this Court denied a petition for rehearing of the denial of certiorari while the petition of the Government was pending in the case at bar (Journal, February 7, 1938, p. 162).

As already noted, the respondent admits (Br. 55–56) that it was competent for Congress to impose this tax in respect of corporations *formed* for the purpose of avoiding the surtax; respondent contends only that Congress is impotent to protect the fisc against availance of *operating* companies for the interdicted purpose. Indeed, it is argued that Congress did not intend to impose this tax upon operating companies, and that the legislative history so shows. It is submitted that there is nothing whatever in that history to justify such a conclusion, and certainly there is nothing in the plain provisions of the statute which does. It provides that the tax shall be levied upon all corporations however formed. It would indeed have been strange had Congress limited the tax to holding companies and actually exempted operating companies therefrom even though they were avowedly

availed of for the interdicted purpose. Congress has never done that.[1]

The provisions of the statute may be justified upon two grounds: First upon the ground that they impose a special income tax and, secondly, upon the ground that they are necessary to implement the provisions of the law in order to prevent tax avoidance.

(A) THE STATUTE IMPOSES A SPECIAL INCOME TAX

The view that the statute imposes a special income tax has been accepted by all the lower Federal appellate courts. See, *e. g.*, *United Business Corp.* v. *Commissioner, supra; Williams Inv. Co.* v. *United States, supra,* p. 233; *A. D. Saenger, Inc.,* v. *Commissioner, supra,* p. 24. Cf. *United States*

[1] In 1928 the House proposed to differentiate between personal holding companies and all other corporations. In this connection, attention is invited to the fact that the statement made by Mr. Garner on the floor of the House, quoted from on p. 45 of the respondent's brief, relates to a proposed new provision for a tax on personal holding companies, supplemented by one on corporations, other than personal holding companies, which were availed of for the interdicted purpose. (See the bills as reported to and passed by the House, also the report accompanying the latter, H. Rep. No. 2, 70th Cong., 1st Sess., pp. 17–18.) Section 105 as thus reported proposed to retain, for the year 1927 only, the substance of the provisions of Section 220 of the Revenue Act of 1926, which is the same in substance as Section 104 of the Revenue Act of 1928 here under consideration. The Senate struck out the proposed new provisions of Section 104 of the House bill, changed the number of Section 105 to 104, and made it applicable to "each taxable year" to which the law applied instead of only to the year 1927. (See the bills as reported to and passed by the Senate;

v. *Hudson,* 299 U. S. 498, 500. In this view the statute is not a penalty at all.[2] Indeed, the court below did not really consider it to be such, but only a tax. True, it characterized the tax as "highly penal" in its nature, but nevertheless considered it to be a tax. Cf. *Helvering* v. *Mitchell,* No. 324, October term, 1937, decided March 7, 1938, and particularly note 15 thereto, wherein the decision of Judge Learned Hand in *United Business Corp.* v. *Commissioner, supra,* was referred to for an exposition of the nature of the provision.[3]

The tax is laid on income, and is imposed for revenue purposes. It was pointed out in the Government's brief in the *Mitchell* case, p. 31, that to deny to Congress the power to impose a higher tax in cases where fraud is the basis for such imposition would cast doubt upon the theretofore unquestioned power of Congress to deal in an appropriate civil manner with numerous types of tax evasion resulting from fraud. This is no less true of cases which do not involve fraud, but only a purpose of

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also the report accompanying the latter, S. Rep. No. 960, same Cong. and Sess., pp. 25–26.) The Senate amendments are numbered 68–70, inclusive. The House receded from its disagreement thereto. (See Conference Report, H. Rep. No. 1882, same Cong. and Sess., p. 1, also the statement of the managers on the part of the House appended to this report, p. 14.) The Court needs hardly to be informed that we are not here dealing with an undistributed profits tax.

[2] A contrary view has been expressed by a district court. See *Charleston Lumber Co.* v. *United States,* 20 F. Supp. 83, 87 (S. D. W. Va.).

[3] Reference has already been made to the *Mitchell* case in note 2 on p. 10 of the Government's brief in chief.

avoiding a tax.[4] If the legislative history of this provision as set out on pp. 77–123 of the respondent's brief proves anything, it proves the truth of the President's statement in his message to Congress of March 3, 1936 (Br. 113) that "This method of evading existing surtaxes constitutes a problem as old as the income-tax law itself." The hitherto futile efforts of Congress adequately to prevent the use of such methods seem only to prove beyond peradventure the vast extent of the evasion, which, as the President pointed out in the same message, in one year alone deprived the Government of $1,300,000,000 in revenue. It would therefore seem idle for the respondent to contend that there is no historic basis or justification for the law as a revenue measure.

The opinion of Congress that the tax here in question is necessary in order to protect and supplement the revenues is beyond challenge. And, by the same token, the classification is entirely reasonable. It is to be observed that the higher rate, or rather the special income tax, is laid upon the income of corporations thus availed of because that income includes amounts which, had they been distributed, would have been subject to another tax. Thus a

[4] It is clear that the tax here does not have fraud as its basis. That was the basis of the tax imposed by Section II–A (2) of the Tariff Act of 1913, c. 16, 38 Stat. 114, 166; but by Section 220 of the Revenue Act of 1918, c. 18, 40 Stat. 1057, the requirement of proof of fraudulent intent was dispensed with. The reason for this is explained in S. Rep. No. 617, 65th Cong., 3d Sess., p. 5, already referred to in note 2, p. 10, of the Government's brief in chief.

clear differentiation is made between income which does not include such items and income which does, and that differentiation is the basis for the difference in tax treatment. Although the rate is high, no one has ever questioned the power of Congress to fix such a rate, and the respondent does not do so.

It is therefore clear that this tax is valid, because we are dealing with a proper subject of taxation, namely, income; because the exaction is designed to protect and augment the revenues; because there is a valid classification, namely, income including items that but for the purposeful failure to distribute them would be subject to another tax; and because the rate is incontestably valid. It is thus apparent that the respondent has entirely misconceived the nature of this tax when it asserts that "it is a direct tax on a purpose, or state of mind" (Br. 40).

Nor is the statute open to the respondent's objection that it is so indefinite as to standard or formula as to render it void under the Fifth Amendment because it is so unreasonable, arbitrary, and capricious as to deprive the respondent of its property without due process of law (Br. 62). The same contention was rejected by the Circuit Court of Appeals for the Second Circuit in *United Business Corp.* v. *Commissioner, supra.* There, as here, the taxpayer relied upon the decision of this Court in *United States* v. *Cohen Grocery Co.*, 255 U. S. 81, to support its contention that the statute was too indefinite to lay down a consitutional criterion of

tax liability. In disposing of this contention, Judge Learned Hand said (p. 756):

> The argument misconceives the scope of those decisions. Standards of conduct, fixed no more definitely, are common in the law; the whole of torts is pervaded by them; much of its commands are that a man must act as the occasion demands, the standard being available to all. The vice of fixing maximum prices is that it requires recourse to standards beyond ascertainment by sellers, by which therefore they cannot in practice regulate their dealings. That is not true of the reasonable needs of a business, which is immediately within the ken of the managers, the supposititious standard, though indeed objective, being as accessible as those for example of the prudent driving of a motor car, or of the diligence required in making a ship seaworthy, or of the extent of proper inquiry into the solvency of a debtor.

Cf. *Williams Inv. Co.* v. *United States, supra,* p. 232.

In the case of *Old Dearborn Co.* v. *Seagram Corp.,* 299 U. S. 183, this Court distinguished the *Cohen Grocery Co.* case, *supra,* as well as the case of *Connally* v. *General Const. Co.,* 269 U. S. 385, 390, also relied upon and quoted from by the respondent (Br. 65). In the *Old Dearborn Co.* case, the contention of fatal vagueness and indefiniteness was primarily directed against the phrase "fair and open competition." The Court said (p. 196) that the point was shown to be lacking in substance by the

very reasoning in the *Connally* case, at pp. 391–392, and the cases there cited, referring specifically *inter alia* to the *Cohen Grocery Co.* case and quoting from p. 92 thereof to the effect that, "for reasons found to result either from the text of the statutes involved or the subjects with which they dealt, a standard of some sort was afforded." And, by way of illustration, the Court pointed out that it had never regarded such phrases, as "fair and open competition" and "unfair *methods* of competition," as being fatally uncertain. If so, how can it be contended that, having regard for the text of the statute and the subject with which it deals, the interdicted purpose is insufficiently described, either as to character of the corporation, kind of tax avoided, or type of accumulations that fall within its purview?[5] Nor is the basis for invoking the presumption less certain, for it is based upon a disclosure that the accumulations were "beyond the reasonable needs of the business," a fact no more difficult of ascertainment than many other questions ~~assigned~~ ARISING under the Revenue Acts. See *Wil-*

[5] The description of other subject matters of taxation depending on purpose is less certain. Take for example, such statutory provision as Section 302 (c) of the Revenue Act of 1926, c. 27, 44 Stat. 9, requiring the inclusion in the gross estate of a decedent of the value of property "To the extent of any interest therein of which the decedent has at any time made a transfer, by trust or otherwise, in contemplation of or intended to take effect in possession or enjoyment at or after his death, except in case of a bona fide sale for an adequate and full consideration in money or money's worth." Cf. *United States* v. *Wells*, 283 U. S. 102.

liams Inv. Co. v. *United States, supra,* p. 232; also *United Business Corp.* v. *Commissioner, supra,* p. 756.

Furthermore, the standard for which the respondent contends would require definiteness in the statement of the relationship between (1) capital and surplus on the one hand and volume of business on the other; (2) reserves and amounts required for expansion, obsolescence, depreciation caused by depressions and recessions, losses caused by strikes, walk-outs, fire, flood, hold-ups, thefts, embezzlement, drought, famine, and other conceivable perils that a business might encounter; and (3) the amount of dividends that must be paid and earnings, in order to avoid the penalty. In short, the respondent contends for a rigid formula, all of whose elements are definitely ascertained and fixed in advance, and which, at the same time, is so all inclusive as to comprehend every conceivable situation in which the special tax is to be imposed. We submit that the charge of indefiniteness is as pointless as the suggestion of the necessity for such a formula. No such standard would be required even in a criminal case. In *Nash* v. *United States,* 229 U. S. 373, 377, the Court said:

> But apart from the common law as to restraint of trade thus taken up by the statute the law is full of instances where a man's fate depends on his estimating rightly, that is, as the jury subsequently estimates it, some matter of degree. If his judgment is

> wrong, not only may he incur a fine or a short imprisonment, as here; he may incur the penalty of death.

See further, in addition to the cases already cited, *Kay* v. *United States,* No. 61, October term, 1937, decided January 31, 1938.

It is clear, therefore, that the statute is valid as a special income tax Act.

(B) THE STATUTE IS NECESSARY TO IMPLEMENT THE PROVISIONS OF THE LAW TO PREVENT TAX AVOIDANCE

The statute may be justified as necessary to implement the collection of the income tax. See *Williams Inv. Co.* v. *United States, supra,* p. 232. As was said in *Almours Securities* v. *Commissioner, supra,* p. 429:

> The subject is within the constitutional power of the legislative department. It is the duty of the Congress to determine what means are appropriate to carry out the purpose of the revenue acts. The end being legitimate and the means being plainly adapted to that end, we think the law is constitutional.

What has been said above (p. 6) to demonstrate the reasonableness of the classification is equally applicable to support the validity of the measure as a means of preventing tax avoidance. The specific objection which the respondent makes to the application of the section to operating companies is that its purpose and effect is not to prevent tax avoidance, but merely to "control and regulate the

dividend policy of domestic corporations so that income not otherwise existing or taxable under the revenue laws and under the constitution may be created and be subjected to taxation" (Br. 53–54). The cases which the respondent relies on in this connection go to the proposition that Congress may not, in order to prevent the doing of an otherwise lawful act, *not within its control,* impose a penalty upon the doing of such act in the guise of a tax. Such, for example, is the *Child Labor Tax Case,* 259 U. S. 34, and the decisions which have followed it (Br. 50–52). No such situation is presented here. It is indisputable that Congress has power to tax stockholders on dividends received from corporations and that it is possible for operating companies to be availed of for the purpose of preventing the imposition of such a tax upon its stockholders by permitting its profits to accumulate. And it cannot be gainsaid that the statute is designed effectively to prevent such avoidance. What the respondent is saying is that Congress is powerless to implement the statute by striking at the point where the blow will be most effective. Its contention that there is no relationship between the tax imposed upon the corporation and the surtaxes upon the shareholder is so obviously untenable as to require no refutation. In any event, it has been effectively disposed of by the Circuit Court of Appeals for the Second Circuit in the *United Business Corp.* case, p. 756.

It is clear, therefore, that the statute is valid as an implement to prevent tax avoidance.

CONCLUSION

For the foregoing reasons, it is respectfully submitted that there is no sound objection to the validity of the statute.

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1937.

No. 723.

GUY T. HELVERING, Commissioner of Internal Revenue,
Petitioner,

vs.

NATIONAL GROCERY COMPANY,
Respondent.

On Petition for a Writ of Certiorari to the United States Circuit Court of Appeals for the Third Circuit.

BRIEF FOR THE RESPONDENT IN OPPOSITION.

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Opinions Below.

The opinion of the Board of Tax Appeals together with the dissenting opinion (R. 17-32) is reported in 35 B. T. A. 163.

The opinion of the Circuit Court of Appeals (R. 172-180) is reported in 92 Fed. (2d) 931.

Jurisdiction.

The judgment of the Circuit Court of Appeals was entered on October 21, 1937 (R. 180).

Petition for certiorari was filed on January 20, 1938.

The jurisdiction of the Court is invoked under section 240(a) of the Judicial Code as amended by the Act of February 13, 1925.

The Question Presented.

The Circuit Court of Appeals, having found that there was no evidence substantial or otherwise to sustain the determination of the Board of Tax Appeals that respondent was availed of during the taxable year for the purpose of preventing the imposition of the surtax upon its sole stockholder, did it err in reversing said determination?

Statute and Regulations Involved.

The statute and regulations involved are set forth in the Appendix, *infra*, pp. 29-33.

Statement.

This case involves the legality of an attempted assessment under Section 104, Revenue Act of 1928, of a penalty tax of $477,360.68 for respondent's fiscal year ended January 31, 1931 (R. 11-14). For that year respondent had paid normal income taxes of $103,616.60, on net income of $863,471.67 (R. 12) reported on its tax return.

Respondent is in the chain grocery business, its principal office being in Jersey City, N. J.

There was no conflict in the evidence before the Board of Tax Appeals. The only witnesses who testified before the Board were called by respondent. In addition to the testimony of witnesses the Board received in evidence a

number of statements taken from respondent's books showing all the details of respondent's business from the date of its incorporation in 1908 to the time of trial, including the number of stores operated each year, gross sales, salary paid Henry Kohl, the sole owner, State and Federal taxes, wages and rents paid, and in short all the important details of the business. The only evidence introduced on behalf of the Commissioner were certain income tax returns of respondent and Henry Kohl, and a statement showing the surplus of the business from its inception. The proofs showed, without contradiction, that the business had grown from insignificant proportions in 1908 to $25,000,000.00 for the year in question. The details will be referred to later.

This is the first case which has come before the Board or the Courts where the Commissioner attempted to apply Section 104 to a mercantile or industrial activity organized prior to the income tax law, which has consistently followed the policy of ploughing its earnings back into the business (R. 31).

In the year under review, although the taxpayer's income tax return showed large earnings, it in fact suffered depreciation in all of its assets far in excess of the earnings reported. Respondent proved that panicky business conditions prevailed in 1930, and that its purpose in not paying dividends was not to avoid the imposition of surtaxes, but to conserve all its resources for business needs. It further proved that it was at the time negotiating the purchase of another large chain of grocery stores, which purchase would have required all its resources. It further proved affirmatively that its capital and surplus were not in excess of the reasonable needs of the business.

(a) Origin of Business.

Henry Kohl, a foreigner, came to America in 1887, when sixteen years of age, without money or property. He worked as a clerk in grocery stores and saved a few hundred dollars (R. 63).

In 1891, having saved $217.00, he and a friend, as partners, bought a grocery store for $500.00. A short time later they bought a second store for $250.00, paying half cash. The partnership dissolved, each partner taking one store.

By 1900, Kohl had purchased two stores.

In 1906, he had three stores and that year incorporated them into Henry Kohl Company, a New Jersey corporation. These were old-time grocery stores doing business on credit.

In 1908, his stores losing money, Kohl conceived the idea of selling groceries on the cash and carry basis in individual packages and organized respondent, National Grocery Company, which opened one store.

After about six months, this store proved very successful and respondent opened additional stores as fast as its limited capital would permit (R. 63, 64).

In 1911, Kohl merged Henry Kohl Company into the National Grocery Company and increased its capital to $200,000.00.

Henry Kohl always owned all the stock of the corporation.

(b) Growth of Business on Its Earnings.

From its organization in 1908 until the year under review (January 31, 1931), respondent pursued the policy of retaining all possible earnings in the business and of constantly expanding on its own earnings. This was the policy

of thrift that Kohl himself had pursued from the day he landed at Castle Garden, a penniless emigrant.

The Company has never been financed or expanded on borrowed money and never sold any stocks or bonds to the public (R. 77). Mr. Kohl never put anything into the business by way of securities or contributions to capital (R. 83).

The capital and surplus of the Company under Kohl's method grew from $20,943.46 in 1908, to $8,138,965.54 as of January 31, 1931 (Ex. 6, R. 136). During this same period, the number of stores grew from three in 1908 to eight hundred and fifteen in 1930. The number of employees grew from a handful in 1908 to twenty-three hundred and thirty-two in 1930. In 1930 the wages paid employees aggregated $3,132,891.99 (Ex. 9, R. 140). The purchases in 1930 aggregated $19,993,937.83, and rents paid aggregated $929,918.70 (Ex. 10, R. 141). In 1930, by discounting its bills, the Company saved $493,719.24 (Ex. 10, R. 141). The Company's gross sales grew from $181,028.11 in 1908, to $25,142,537.41 in 1930 (Ex. 7, R. 138). In 1930, the Company owned and operated a large bakery (Ex. 17, R. 150), an office building, warehouses, and garage (Exs. 16 and 18, R. 148 and 152). These were built to serve between 1,500 and 2,000 stores (R. 78). In every year from 1908 to 1932 the number of stores increased (Ex. 4, R. 132). Sales increased every year up to 1930 excepting in 1921 and 1922 (R. 138).

From the first year the Company was in business it invested surplus money in stocks, and purchased its first bonds in 1917. Its stockholdings increased from $750.00 in 1907 to $2,676,061.47 in 1930 (cost figures), and that date its bonds cost $313,391.27 (Ex. 6, R. 136).

A list of the securities owned with their cost and market at the beginning and end of the taxable year ended January 31, 1931, appears as Exhibit 15 (R. 146).

Mr. Kohl testified that the surplus funds of the Company were invested in securities "so that when we would need it we would have it. All corporations do that more or less. * * * It was part of our business. We carried that money, of course, principally to have the money on hand and get something for it. * * * You know, you can turn that stuff over in the morning, in a couple of hours, and you have your money if you want it" (R. 75, 76). Corroborated by Miss Mullins (R. 77).

From the incorporation of the Company in 1908 to January 31, 1931, Henry Kohl's salary had aggregated $1,026,570.00, while in the period from 1912 to January 31, 1931, respondent had paid Federal income and excess profits taxes aggregating $1,842,719.79 (Ex. 4, R. 132).

(c) No Gains Accumulated in the Taxable Year.

Respondent actually had no gains or profits in the year under review.

The income tax return filed by respondent for the fiscal year ended January 31, 1931, showed

Net income taxable under Section 13 of the Revenue Act of 1928	$863,471.67
Non-taxable income	90,858.40
Net income	$954,330.07

(See Commission's letter R-11 and Statement R-12, 13.)

The Company paid normal income taxes aggregating $103,616.00 (R. 14).

Exhibit 15 (R. 146) shows that respondent suffered depreciation in securities for its fiscal year ended January 31, 1931, aggregating $943,517.42.

Mr. Ferguson (R. 93), Mr. Field (R. 87), and Mr. Armbruster (R. 96) testified that the local bank stocks should be eliminated from the statement because they were unsalable, had no liquidity, and could not be used as collateral for loans. In other words, the Corporation could not raise money by selling them; and they had lost all their value for obtaining credit or borrowing money.

Therefore the following securities must be eliminated from Exhibit 15 (R. 146) to see the true condition of respondent:

Commercial Trust Company of New Jersey	$ 768,240.00
First National Bank of Jersey City	38,600.00
Hudson County National Bank	127,654.00
First National Bank of Hoboken	15,360.00
New Jersey Title Guarantee & Trust Company	60,288.00
Trust Company of New Jersey	58,480.00
Total	$1,068,622.00
Deducting from the market value of all securities 1/31/31	$2,125,434.50
the estimated value of the local bank stocks, as shown above	1,068,622.00
there remains a market value of all the securities in the portfolio of	$1,056,812.50

The evidence thus establishes that National Grocery Company between January 31, 1930, and January 31, 1931, suffered depreciation as follows:

Securities (R. 146)	$ 943,517.42
Inventory*	376,457.56
Real Estate**	125,000.00
Total	$1,444,974.98
If we add to that figure the quoted market value of the local bank stocks, to wit	1,068,622.00
the gross depreciation suffered in the fiscal year ended 1/31/31, was	$2,513,596.98
Deducting from this figure total net income (p. 6, *supra*)	954,330.07
we find that in the year 1930 the Company's net worth shrank in value	$1,559,266.91

What more graphically could show the necessity of an adequate surplus than such shrinkages!

Therefore the Company had in fact no accumulation of gains and profits within the meaning of Section 104 in its fiscal year ended January 31, 1931.

The Company did not sell any of the above securities to make a deductible loss under the Revenue Act, although it could readily have done so, and wiped out all the net income and saved the normal income tax of $103,616.60 which it paid. Such realized losses would also have obviated all questions under Section 104.

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* From Ex. 6, R. 136—Mullins estimated the inventory loss when testifying at $200,000.00–$250,000.00 (R. 81).

** R. 98.

(d) The Evidence as to Respondent's Purpose.

The testimony is without dispute that the intention of the taxpayer from its organization up to the date of trial was to expand; to build up a "chain" of stores; to continually increase the number of stores in its chain.

An examination of the evidence discloses that this purpose existed from the formation of the National Grocery Company, and that from that beginning (at a time when there was no income tax, or undistributed profits tax) the taxpayer consistently adhered to the policy of accumulating gains and profits for the purpose of building up the business. This was Kohl's policy while he lived in the back of a store, cooked his own meals, and as he stated it, lived "as all poor devils do" (R. 63).

Mr. Kohl, respondent's President, testified the purpose of National Grocery Company was to open more and more stores; that they wanted more stores.

After relating his early struggles he said, speaking of the merger of the Henry Kohl Company with National Grocery Company in 1911:

> "After this merger I had fifty-seven stores. It is quite a question how I financed the additional stores. I did it by using all of the money I could borrow and what little I made in profits" (R. 65).
>
> * * * * * * *
>
> "As time went on and by the method of keeping all of my profits in the business, except what were necessary for my bare living expenses, 'I was independent and did not want to sell it' " (stock in his company).
>
> * * * * * * *

"I expanded the business year by year * * * and financed the expansions with the profits I made from year to year, leaving them right in the business" (R. 66).

* * * * * *

"The National Grocery Company had in mind opening more and more stores. I always had great big ideas" (R. 67).

"Our system was right and the public wanted them, but we could not carry it out all the time. Competition came, but we wanted plenty of stores. We had to have a certain amount of capital in order to have credit. Your credit depends on your statement. 'If you don't have a decent statement you cannot buy your merchandise right or do anything right.' The National Grocery Company had to buy large quantities of merchandise all the time. Ever since we have been able to discount our bills we have been doing it. It is a very important thing in our business to get the discounts and pay cash for merchandise. That is the inner profit of the business.

"For the year 1930 the discounts amounted to $434,000. The purchases for that year were in excess of $19,000,000, and the discounts were almost two per cent of that figure. In order to make those purchases and take our discounts we had to have large capital" (R. 67, 68).

Again, Mr. Kohl testified that he had been on the lookout at all times to buy an existing chain of stores. He said that in 1929 and 1930 Mr. Bohack of the H. C. Bohack Company, in Brooklyn, was alive, and offered to sell his chain of five or six hundred stores, and he seriously considered purchasing part, if not the whole of the business. He made a careful survey of the business to see if it was profitable to purchase, but while the negotiations were pending Mr.

Bohack became ill and died. The negotiations were resumed as late as last year (1936). The Bohack Company is a large concern, five or six million dollars (R. 70).

Mr. Kohl also testified that he kept all the earnings in the business, because "I needed them in the business—always needed them in the business. I never had any too much money in my business." (R. 72).

In this connection Mr. Kohl said:

> "* * * Even with all the capital that the Company had we had to borrow money from the banks occasionally as it was needed. We needed it to buy butter and eggs and put them in storage, and to buy merchandise when it was the right time to buy. Frequently you need more money that you have got. It takes all of the money we have got to swing that. We buy butter every day, but in June we buy butter for the next Winter.
>
> Q. How about coffee—do you buy that in large quantities? A. That all depends.
>
> Q. On what? A. If war were declared tomorrow we would buy a year's supply and would be fortunate to have the money to do it with" (R. 72).

Again:

> "It has been the habit with us to keep in the business every possible dollar, and let that accumulate for the benefit of the business. I think it is good business judgment and I guess everybody else does. The bankers tell you that. If we had adopted a different policy and in the good years from 1920 to 1930 had drawn out of the business a large part of our profits, I do not think we would have been able to withstand the effect of this depression the way we have. I think those concerns who did do that have gone" (R. 73).

He testified that:

> "I did not refrain from paying dividends in the National Grocery Company in 1930 in order to avoid the payment of any government taxes. I have never done that" (R. 75).

Miss Mullins, Treasurer of the Company, who had been associated in the business with Mr. Kohl since 1897, when he had one store, fully corroborated Mr. Kohl's testimony (R. 77). She said:

> "It has been Mr. Kohl's policy from the formation of the business that he could make more money by reinvesting the earnings in the business than in any other type of investment" (R. 77).
>
> * * * * * *
>
> "When Mr. Kohl had one store he promised me he would have ten some day. After he had ten and he thought if I would stay a little longer maybe he would have a hundred, and that has been his policy right along" (R. 78).
>
> * * * * * *
>
> "I believe in 1919 we had two hundred stores. At that time Mr. Kohl was figuring on having a thousand. When he got up to six and eight hundred stores his plan was to have two thousand" (R. 78).

She testified that the present warehouse and bakery and machinery are built to take care of between 1,500 and 2,000 stores (R. 78). This fact shows that the purpose of the management was to increase the number of stores as opportunity offered to double the 815 operated in 1930.

She also said:

> "It is my opinion, as Treasurer of the Company, that in the year 1930 the surplus was not in excess of the reasonable needs of the business, and is not today, although conditions are different. In order to finance the purchase of $20,000,000 worth of merchandise and pay a million dollars in rents per annum, the Company required its surplus, in my opinion. There were times even at that when we were short of cash, and had to borrow temporarily from the banks in order to pay for incoming merchandise" (R. 79).

Miss Mullins corroborated Mr. Kohl's testimony about negotiations with Mr. Bohack in 1930 for the purchase of his business, and also negotiations for the purchase of a chain of stores in Paterson, New Jersey (R. 79, 80).

Mr. Field testified that a company like respondent to get the full advantage of a chain store business must cover with stores the total territory that can be reached with trucks from its central warehouses (R. 87, 88).

At Mr. Kohl's request Mr. Field tried to induce the owners of one chain of stores to sell to respondent (R. 89).

The management of respondent saw values of everything steadily declining in the year under review. They were negotiating a great expansion through the acquisition of the H. C. Bohack chain of stores in Brooklyn and Long Island.

> "Any conservative management would have conserved all its ready cash, because they did not know what the future would bring forth" (Field, R. 91; Ferguson, R. 92, 93).

The Board's Decision.

The Board of Tax Appeals divided eight to seven. The findings of fact and opinion of the majority confirming the assessment by the Commissioner completely ignored the evidence proving respondent's need of large capital in these particulars:—(a) of the number of employees and wages paid; (b) rents paid; (c) amount of purchases; (d) the testimony of Mr. Kohl, Miss Mullins, Mr. Field and Mr. Ferguson that the capital and surplus was not in excess of the reasonable needs of the business; (e) the testimony of Mr. Kohl and Miss Mullins relative to plans for expansion and purchases; (f) the testimony of Mr. Kohl and Miss Mullins that the Company did not have any intention of evading taxes in not paying dividends; (g) that for the year in question the Company in fact suffered a net loss when the market value of its assets was considered, although an examination of the income tax return on the Government blank showed net profits on its face.*

The majority opinion and findings of fact stressed the earnings of the Company, its investment in securities, its failure to pay dividends, loans to Mr. Kohl in 1930 of $140,000 and prior loans, and concluded that petitioner was availed of for the prohibited purpose (R. 18-24).

The majority of the Board proceeded on the erroneous assumption that the presumption created by Section 104(b) of the statute cast the burden on the taxpayer of proving that it was not availed of for the prohibited purpose, and

---

* The income tax law does not take into consideration depreciation in the portfolio of securities and real estate, but only gains and losses determined by sales. In this taxpayer's method of accounting, the inventory was carried at cost or market, whichever was lower, and this method was followed in the year under review.

did not have gains and profits in excess of the reasonable needs of the business.

The opinion of the Board says:

> "Does the evidence overcome this *prima facie* presumption" (R. 22)?

The Board concluded:

> "We are also of the opinion that the evidence of record does not rebut the *prima facie* presumption created by the statute" etc. (R. 23).

The Commissioner had offered no proof before the Board as to what the reasonable capital needs of respondent are. No one will contend that it needs no capital. Without adequate capital it could not have discounted its bills payable, and such discounts in the year under review amounted to $493,719.00 (Ex. 10, R. 141), or fifty-seven per cent of the net earnings for the year.

The respondent had affirmatively proved by its President and Miss Mullins that it needed all of its capital in its business.

The Board of Tax Appeals made its finding from an examination of the balance sheet alone, wholly disregarding the testimony of Mr. Kohl, Miss Mullins, Mr. Field, and Mr. Ferguson, that respondent's capital and surplus were not in excess of the reasonable needs of the business.

Likewise, the Board's conclusion that respondent's purpose in not paying a dividend in 1930 was to avoid the imposition of the surtax on Mr. Kohl, was supported by no evidence. There was nothing whatsoever to support it except the statutory presumption, and respondent having gone forward with its proofs and having affirmatively shown that

it had no such purpose (*United Business Corporation* vs. *Commissioner*, 62 Fed. (2d), 754; certiorari denied, 290 U. S., 635), the presumption automatically fell out of the case.

> *Pariso* vs. *Towse*, 45 Fed. (2d), 962 (*infra*, p. 21).

The minority of seven, speaking through Member Mellott, took into consideration the testimony above referred to that had been ignored by the majority of the Board, and concluded:

> "The inquiry as to whether there has been an accumulation of surplus beyond the reasonable needs of the business is not determinative of the ultimate question to be decided. Even if the evidence be sufficient to show that there was an unreasonable accumulation—which, however, I do not believe has been shown in this case—this merely raises a rebuttable presumption of the existence of the crucial purpose. Such presumption is overcome by the evidence in this case which shows an absence of such purpose. The corporation merely continued its long established practice of 'ploughing its earnings back into the business.' Indubitably it had in the earlier years no 'purpose of preventing the imposition of the surtax upon its shareholders', for there was no surtax to escape. There had been no 'sudden change of policy, coincident with large increases in the surtax rates, (which) might * * * betray a purpose to accumulate against a season more propitious for distribution.' (*United Business Corporation*, 62 Fed. (2d) 754). It had pursued the same policy throughout the years" (R. 30, 31).

The Decision of the Circuit Court of Appeals.

In due time the respondent appealed to the United States Circuit Court of Appeals for the Third Circuit, and assigned seventeen assignments of error (R. 39-44).

The Circuit Court of Appeals, in an opinion by Judge Buffington, carefully reviewed all the evidence that was before the Board, and said:

> "We limit ourselves to holding that the Tax Board had before it no proof, substantial or otherwise, to support its imposition of this penalty tax. Its judgment is therefore reversed" (R. 172, 178).

ARGUMENT.

I.

No new question of law is involved.

Petitioner contends that the Circuit Court of Appeals so far departed from the accepted and usual course of judicial procedure as to call for the exercise of this Court's power of supervision.

Two months ago, petitioner filed a brief in this Court opposing the granting of a writ of certiorari in *Almours Securities, Inc.* vs. *Guy T. Helvering, Commissioner of Internal Revenue (No. 613 October Term)*, in which petitioner said (p. 13):

> "Examination of *National Grocery Co.* v. *Helvering, supra,* discloses no conflict with the decision below. The Circuit Court of Appeals for the Third Circuit merely held 'that the Tax Board had before it no proof, substantial or otherwise, to support' it.

"Both that court and the court below treated the question before them as one of fact and directed their inquiry to the question whether or not the ultimate finding of the Board had any substantial support in the evidence in the case. Because of the supposed nature of the evidence in the *National Grocery* case, the court held that the ultimate finding had no support in the evidence. Both courts applied the same legal principles of judicial review. The cases diverged because of differences in the analyses of fact situations and the state of the records presented in the two cases.

"The comparative analysis drawn by the petitioner (Br. 30) between the cases ignores the very consideration given predominant weight in the *National Grocery* case. The petitioner here was a mere holding or investment corporation (see *infra*, pp. 14-18), which fact alone raises a statutory presumption of the interdicted purpose, while the National Grocery Company was an actively operating company. The court there concerned itself with showing that the Government had not submitted proof rebutting the taxpayer's evidence to the effect that the sums withheld were reasonably necessary for a rapidly expanding grocery store business, a consideration which in itself is obviously sufficient to avoid any conflict with any ruling of law in the instant case."

In a footnote at the bottom of page 12 of said brief, the Government said:

"A dictum in the *National Grocery* case indicates that the court viewed the decision as to the purpose for which the corporation was formed or availed of as a question of mixed law and fact. This statement did not enter into the decision of the case."

Certiorari in the *Almours Securities Company* case was denied January 10, 1938.

II.

The evidence before the board was not disputed.

In its second reason for the issuance of a writ petitioner contends that the Circuit Court of Appeals substituted its judgment for that of the administrative body.

What the Board of Tax Appeals actually did, was wholly to disregard a large portion of respondent's evidence, particularly the evidence as to what motivated respondent's business conduct, the purpose for which it accumulated its earnings, its need of large capital for operating and expansion purposes and the sworn testimony that its surplus was not in excess of the reasonable needs of its business and was not accumulated to avoid any taxes.

No witness for the Commissioner testified that the ratio between capital and surplus and business done was too large. No witness contradicted the taxpayer's evidence in any respect.

The Board of Tax Appeals merely picked out of the taxpayer's balance sheet certain items, compared the ratio between the capital and the surplus, noted that the corporation had a surplus of $7,938,965.54 (R. 23) (which figure disregarded all depreciation of every kind), and that it had loaned a comparatively insignificant amount to its principal stockholder, and from those facts alone concluded that since its income tax return for 1930 showed large net earnings which it did not distribute in dividends, it therefore had the purpose to evade the imposition of the surtax.

The Board entirely ignored the most important factor, *i. e.*, the ratio between the capital and surplus, on the one hand, and business done, on the other. Respondent's annual turnover was 6 to 8 times its working capital (R. 86).

The Board entirely disregarded the proven fact that this corporation, which operated a chain of grocery stores throughout Northern New Jersey, Staten Island, and a part of New York, also owned and operated a large central distributing plant, a large administrative building, a large bakery, garages, storage warehouses, a fleet of automobile trucks, and at all times carried large stocks of merchandise in its stores and warehouses to serve over 100,000 customers daily (R. 83). Capital was the life-blood of this business.

The Board ignored the fact that the taxpayer had 2,332 employees, who had to be paid regularly wages aggregating $3,132,891.99 per annum, and that it had annual rents to pay aggregating $929,918.70, as well as State, City and Federal taxes, to say nothing of bills for merchandise aggregating $19,998,937.83 in the year under review.

The Board ignored the fact that sound business principles require the accumulation of surplus in times of plenty against the coming of times of famine, the likelihood of wars, recession, depression, strikes, drought, floods and the consequent scarcity of merchandise.

Respondent, as we have heretofore shown, proved affirmatively and convincingly that its capital and surplus were not in excess of the reasonable needs of the business, and that it did not fail to pay dividends in the year under review to avoid the imposition of surtaxes on its sole stockholder. The Government introduced no evidence; and as a matter of law the presumption contained in Section 104(b)

disappeared when the taxpayer went forward with sworn testimony and overcame the presumption.

See *Pariso* vs. *Towse,* 45 Fed. (2d), 962, where Judge Hand said:

> "In *Potts* vs. *Pardee, supra,* page 433 of 220 N. Y., 116 N. E., 78, and *Rose* vs. *Balfe,* 223 N. Y., 481, 486, 487, 119 N. E. 842, it was said that the presumption disappears upon any 'substantial' evidence in defense; and this would appear to imply no more than that the defendant in the prescribed situation must proceed or lose." . . . "Thus it follows that the office of a presumption must disappear when the opposite side puts in proof, and the party charged with the burden of proof must fail, if he goes no further, or cannot use his adversary's evidence as support of the affirmative. To hold otherwise would be to impose the burden of proof upon the party having the negative."
>
> *Western & A. R. Co.* vs. *Henderson,* 279 U. S. 639.

In the face of the convincing testimony that respondent corporation did not have more capital than its business required, and occasionally was obliged to borrow for short periods to pay for incoming merchandise (R. 79), what was there to support the Board's finding that respondent's profits were in excess of the reasonable needs of the business?

Every business must have capital. Even the newsboy must have a few pennies with which to purchase the papers he sells on the street corner. No corporation can grow and have a healthy business that distributes all its earnings. The capital required to run one business would be wholly inadequate for another business. The National Grocery

Company with 2,300 employees and 800 stores requires far more capital than the grocer with one store and three employees.

There was not a particle of evidence before the Board to warrant it in making the conclusion it did.

We submit that the Circuit Court of Appeals could properly have made no other finding in the face of the undisputed testimony contained in this record.

III.

The purpose to evade surtaxes is not proved by mere showing that a corporation is able to pay dividends.

The petition for certiorari charges that the Court below overlooked facts indicating that a sizeable portion of respondent's profits for the taxable year could have been declared as a dividend, without curbing in the slightest the reasonable needs of the business (p. 15), contending (1) that the accumulations were not needed to acquire new stores; (2) they were not needed in the business, and (3) they were not needed because of the depreciation taxpayer suffered.

This argument entirely disregards the fact found by the Board, that:

> "For many years the petitioner has contemplated greatly expanding the number of stores operated. For a time it negotiated for the purchase of stores in Paterson, New Jersey, and also for stores in New York City proper, and for a large chain of stores in Brooklyn, New York. The petitioner has not, however, made the contemplated expansions because in

> the opinion of the petitioner's president, Henry Kohl, the stores could not be purchased at what he regarded as a fair price'' (R. 18, 19).

The evidence shows that these negotiations were carried on in 1929 and 1930 (Kohl, R. 70; Mullins, R. 79, 80).

Mr. Kohl testified that the H. C. Bohack Company, which he was negotiating for, was a large business, running into five or six million dollars (R. 70).

If this purchase had been made respondent would have needed every dollar of its surplus.

This case cannot be considered or decided on the same basis as that of a corporation formed by a rich man, who transfers to it his cash and securities in exchange for stock, and uses the corporation as a means of tax avoidance. Such a corporation needs very little money, and it may be that Section 104 requires such a corporation to distribute a large part of its net earnings.

To enforce the same rule on corporations like respondent, which are engaged in an active mercantile and manufacturing business, would result in the stifling of business. What business can continue to grow and expand if it is to be subjected to the normal income taxes and the fifty per cent penalty tax of Section 104?

It is to be noted that Section 104 does not specify how it can be avoided by the payment of dividends; what dividends should be paid; what surplus a business may properly have.

An attempt was made to assess a penalty tax of fifty per cent under Section 220 of the former law (now Section 104) on National Grocery Company for its fiscal years ended January 31, 1923, and January 31, 1924. The tax was

set aside on appeal to the General Counsel of the Bureau of Internal Revenue (Ex. 1, R. 105).

Again an attempt was made to assess the penalty under Section 220 on respondent for the fiscal year ended January 31, 1928. Respondent protested and after hearing the protest was sustained (Ex. 1, R. 125).

The record below shows a tremendous growth in this business after these attempts were made. For the year ending January 1925, the Company had 1,462 employees, paid them wages of $1,683,947.70 (Ex. 9, R. 140), and operated 482 stores with gross sales of nearly $16,000,000.00 (Ex. 7, R. 138). For the fiscal year ended January 31, 1929, the Company had 2,210 employees, paid them wages of $2,825,615.53 (Ex. 9, R. 140), and operated 782 stores, with gross sales of $24,116,343.72 (Ex. 7, R. 138). Two years later (the fiscal year under review) the number of employees had increased by 122, wages had increased by $307,000.00 per annum, stores had increased from 782 to 815, and gross sales had increased by over $1,000,000.00.

Is it probable that any such increase would have followed the collection of the fifty per cent penalty in 1924, 1925 or 1928?

The test under Section 104 is not whether a corporation is able to pay dividends but rather, is it used as an instrument of tax avoidance. The question raised by the statute is whether gains and profits are permitted to accumulate for the *purpose* of avoiding surtaxes that otherwise would fall on the owner. This statute does not impose a tax on corporations because they do not pay dividends when they might do so—as petitioner seems to contend. That is the theory of later legislation imposing a surtax on undistributed profits of corporations generally (Rev. Act 1936, Sec. 14; 49 Stat., 1655).

No intention of the management of this business to avoid taxes can be found in this record. To the contrary, from the beginning of this corporation in 1908 to the year under review there has been a steady growth year by year through the policy of ploughing all possible earnings back into the business. The net result is that the Government has received in taxes more than the owner; employees received more in wages for the year under review than the owner received during the entire history of the business, and those engaged in trade and commerce have sold the Company many millions of dollars of merchandise.

Loans to Kohl Did Not Prove the Forbidden Purpose.

In the year under review Mr. Kohl temporarily borrowed from his Company $140,000.00. He had developed a heart condition and used $40,000.00 to purchase a residence in Florida. He borrowed $100,000.00 in order to make a contribution to complete a home for the Young Women's Christian Association in Jersey City (R. 70). He gave the Company demand notes for the amounts (R. 71). The amounts loaned were entered on the books under the head of "Notes receivable" and appeared in every statement the Company made (R. 81). The reason he borrowed from the Company instead of declaring a dividend was that he expected to repay and the surplus account would not be lowered, whereas if he had declared a dividend the money would be permanently out of the business (R. 79).

Mr. Field, President of the Commercial Trust Company of New Jersey, testified that:

> "I don't think it would have made much difference whether he borrowed the money from the bank or his own company" (R. 89).

On cross examination he said:

> "I presume that Mr. Kohl's borrowings from the corporation was a good asset for the corporation" (R. 92).

On re-direct:

> "We have considered the item of $610,000 owed by Mr. Kohl to National Grocery Company an asset of the Company, collectible whenever the Company elected to collect it" (R. 92).

In effect the Commissioner conceded these loans are good and collectible for he includes the notes receivable in the surplus (Exs. 5 and 6, R. 134, 136).

The element of loans by a corporation to a stockholder is not in any sense a fair test of a purpose to evade taxes.

Suppose a corporation is in the banking business, all of its stock being owned by one man. The business of a bank is to loan money. If the bank loaned money to its sole stockholder against his note, could it be said that because he borrowed from the bank which he owned, that thereby an intention was shown to use the corporation to evade taxes?

The facts conclusively show that Kohl borrowed from his corporation temporarily. He so handled the matter that for the purposes of credit the surplus was not depleted. The fact is that within seven weeks of the end of the year, he repaid $60,000.00 of his temporary borrowings, during the following year he paid off $65,000.00, and May 4, 1933 he paid off $86,000.00 (R. 142). The Commissioner's notice of the attempt to assess this penalty tax was dated April 25, 1934 (R. 11) and was received about a year after all the

loans in the year under review, and a part of the earlier loans had been repaid. This clearly demonstrates that the purpose of the stockholder was to retain all assets in the corporation, according to its historic policy, for continued growth and expansion.

In *United States* vs. *Tway Coal Sales Co.*, 75 Fed. (2d) 336, the taxpayer sued for the recovery of taxes paid after an assessment under Section 220 of the former law. Judgment for the taxpayer in the District Court was affirmed by the Circuit Court of Appeals (Sixth Circuit), despite the fact that the sole stockholder had borrowed relatively larger sums from his corporation than Kohl did from National Grocery Company.

IV.

Section 104 being a penal statute, must be construed strictly and in the light most favorable to the taxpayer.

Section 104 of the Revenue Act of 1928 imposes a penalty of 50 per cent *of the income,* including dividends and income from tax exempt securities, and all other income, while Section 293(b) of the Revenue Act of 1928 provides that for fraud the penalty is *50% of the tax.*

> "If any part of any deficiency is due to fraud with intent to evade tax, then 50 per centum of the total amount of the deficiency (in addition to such deficiency) shall be so assessed, collected, and paid, in lieu of the 50 per centum addition to the tax provided in Section 3176 of the Revised Statutes, as amended" (Sec. 293 (B), Rev. Act, 1928).

Since Section 104 imposes a penalty far greater than for fraud, it should be construed most strongly against the Government.

Gould vs. *Gould*, 245 U. S. 151;
Crocker vs. *Malley*, 249 U. S. 233;
U. S. vs. *Field*, 255 U. S. 262;
Smietanko vs. *First Trust Bk.*, 257 U. S. 606;
Shwab vs. *Doyle*, 258 U. S. 534;
U. S. vs. *Merriam*, 263 U. S. 188;
Hecht vs. *Malley*, 265 U. S. 156;
Reinecke vs. *Northern T. Co.*, 278 U. S. 348;
Aluminum Castings Co. vs. *Routzahn*, 282 U. S. 100;
Old Colony vs. *Commissioner*, 284 U. S. 561.

Conclusion.

We respectfully submit that the decision of the Circuit Court of Appeals is correct. The Court below finding that there was no evidence to support the action of the Board properly reversed.

Respectfully submitted:

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February, 1938.

Appendix.

Revenue Act of 1928, c. 852, 45 Stat. 791:

SEC. 104. ACCUMULATION OF SURPLUS TO EVADE SURTAXES.

(a) If any corporation, however created or organized, is formed or availed of for the purpose of preventing the imposition of the surtax upon its shareholders through the medium of permitting its gains and profits to accumulate instead of being divided or distributed, there shall be levied, collected, and paid for each taxable year upon the net income of such corporation a tax equal to 50 per centum of the amount thereof, which shall be in addition to the tax imposed by section 13 and shall be computed, collected, and paid upon the same basis and in the same manner and subject to the same provisions of law, including penalties, as that tax.

(b) The fact that any corporation is a mere holding or investment company, or that the gains or profits are permitted to accumulate beyond the reasonable needs of the business, shall be *prima facie* evidence of a purpose to escape the surtax.

(c) As used in this section the term "net income" means the net income as defined in section 21, increased by the sum of the amount of the dividend deduction allowed under section 23 (p) and the amount of the interest on obligations of the United States issued after September 1, 1917, which would be subject to tax in whole or in part in the hands of an individual owner.

(d) The tax imposed by this section shall not apply if all the shareholders of the corporation include (at the time of filing their returns) in their

gross income their entire distributive shares, whether distributed or not, of the net income of the corporation for such year. Any amount so included in the gross income of a shareholder shall be treated as a dividend received. Any subsequent distribution made by the corporation out of the earnings or profits for such taxable year shall, if distributed to any shareholder who has so included in his gross income his distributive share, be exempt from tax in the amount of the share so included.

Subdivisions (a) and (b) of Section 220 of the Revenue Act of 1924, c. 234, 43 Stat. 253, and subdivisions (a) and (b) of Section 220 of the Revenue Act of 1926, c. 27, 44 Stat. 9, are substantially identical with subdivisions (a) and (b) of Section 104 of the Revenue Act of 1928.

Treasury Regulations 74, promulgated under the Revenue Act of 1928:

ART. 541. *Taxation of corporation utilized for evasion of surtax.*—Section 104 is designed to discourage the formation or use of a corporation for the purpose of preventing the imposition of surtaxes upon its shareholders, through the device of permitting its gains and profits to accumulate instead of being distributed. If a domestic or foreign corporation is so formed or availed of, it is subject to a tax at the rate of 50 per cent upon its net income in addition to the tax imposed by section 13. However, the additional tax at the rate 50 per cent does not apply for 1928 or any subsequent taxable year if all the shareholders of the corporation include (at the time of filing their returns) in their gross income their entire distributive share, whether distributed or not, of the net income of the corporation for such year or years. Any amount so included in the gross income of a shareholder shall be treated as a divi-

dend received, and any subsequent distribution made by the corporation out of the earnings or profits for such taxable years shall, if distributed to any shareholder who has so included in his gross income his distributive share, be exempt from tax in the amount of the share so included.

ART. 542. *Purpose to escape surtax.—Prima facie* evidence of a purpose to escape the surtax exists where a corporation is a mere investment company, where a corporation has practically no business except holding stocks, securities, or other property and collecting the income therefrom or investing therein, or where a corporation other than a mere holding or investment company permits its gains and profits to accumulate beyond the reasonable needs of the business. The statutory presumption that a mere holding or investment company is subject to the additional tax imposed by section 104 may be overcome if the corporation can show, either by reason of the fact that it distributed a large portion of its earnings for the year in question, or that its stock was held not by the members of a family or of a small group but by a large number of persons and in comparatively small blocks, or by other evidence, that it was not availed of for the purpose of preventing the imposition of the surtax upon its shareholders.

The business of a corporation is not merely that which it has previously carried on, but includes in general any line of business which it may legitimately undertake. However, a radical change of business when a considerable surplus has been accumulated may afford evidence of a purpose to escape the surtax. When one corporation owns the stock of another corporation in the same or a related line of business and in effect operates the other corporation, the business of the latter may be considered

in substance the business of the first corporation. Gains and profits of the first corporation put into the second through the purchase of stock or otherwise may therefore, if a subsidiary relationship is established, constitute employment of the income in its own business. To establish that the business of one corporation can be regarded as including the business of another it is ordinarily essential that the first corporation own substantially all of the stock of the second. Investment by a corporation of its income in stock and securities of another corporation is not without anything further to be regarded as employment of the income in its business.

ART. 543. *Unreasonable accumulation of profits.*— An accumulation of gains and profits is unreasonable if it is not required for the purposes of the business, considering all the circumstances of the case. It is not intended, however, to prevent reasonable accumulations of surplus for the needs of the business. No attempt can be made to enumerate all the ways in which gains and profits of a corporation may be accumulated for the reasonable needs of the business. Distributions made by a corporation shortly after the close of its taxable year shall be taken into consideration in determining the reasonableness of the amount of earnings and profits of the corporation retained by it for such year. Undistributed income is properly accumulated if invested in increased inventories or additions to plant reasonably needed by the business. It is properly accumulated if retained for working capital required by the business, or in accordance with contract obligations placed to the credit of a sinking fund for the purpose of retiring bonds issued by the corporation. In the case of a banking institution the business of which is to receive and loan money, using capital, surplus, and deposits

for that purpose, undistributed income actually represented by loans or reasonably retained for future loans is not accumulated beyond the reasonable needs of the business. The nature of the investment of gains and profits is immaterial if they are not in fact needed in the business. It is an unreasonable accumulation of gains and profits by corporations with the purpose of enabling their shareholders to escape surtaxes on such gains and profits which subjects such corporations to the additional tax imposed by section 104. Among other things, the financial condition of the corporation at the close of the taxable year and the manner in which its funds are invested at that date, determine the reasonableness of the accumulations.

For the purpose of section 104 of the term "net income" means the net income of the corporation as defined in section 21 increased by the sum of (1) the amount received as dividends and allowed as a deduction by section 23 (p), plus (2) the amount of interest on obligations of the United States issued after September 1, 1917, which would be subject to tax in whole or in part in the hands of an individual owner. The Commissioner, or any collector upon direction from the Commissioner, may require any corporation to furnish a statement of its accumulated gains and profits, the name and address of, and number of shares held by, each of its shareholders, and the amounts that would be payable to each, if the income of the corporation were distributed. (See section 149 (c).)

Articles 352 and 353 of Treasury Regulations 65 and Articles 352 and 353 of Treasury Regulations 69 are substantially identical with Articles 542 and 543 of Treasury Regulations 74.

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1937.

No. 723.

GUY T. HELVERING, Commissioner of Internal Revenue,
Petitioner,

vs.

NATIONAL GROCERY COMPANY,
Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT.

BRIEF FOR RESPONDENT.

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Appendix.

Containing a history of legislation attempting to compel distribution of corporate earnings commencing with the Tariff Act of 1913 and including all subsequent legislation on the same subject, testimony concerning the meaning of the law before the Committee investigating the Department of Internal Revenue in 1925, Statement by Secretary Mellon, statements of members of the Congress during debates in the Congress, and reports of congressional committees; and showing how the law has been changed and developed to the Revenue Act of 1936 which imposed a graduated tax on undistributed earnings of corporations at the suggestion of President Roosevelt 74

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1937.

GUY T. HELVERING, Commissioner of Internal Revenue, Petitioner, *vs.* NATIONAL GROCERY COMPANY, Respondent.	No. 723.

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT.

BRIEF FOR RESPONDENT.

Opinions Below.

The opinion of the Board of Tax Appeals, together with the dissenting opinion (R. 17-32), is reported in 35 B. T. A. 163. The opinion of the Circuit Court of Appeals for the Third Circuit (R. 172-180) is reported in 92 F. (2d) 931.

Jurisdiction.

The judgment of the Circuit Court of Appeals was entered on October 21, 1937 (R. 180). The petition for certiorari was filed January 20, 1938, and was granted February 28, 1938. The jurisdiction of this Court is conferred by Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

Questions Presented.

(1) Whether the Circuit Court of Appeals erred in reversing the determination of the Board of Tax Appeals which held that taxpayer was availed of for the purpose of preventing the imposition of the surtax upon its stockholders, the Government having offered no proof on the subject of taxpayer's purpose and taxpayer's officers and two expert witnesses having testified that the corporation was formed prior to the Sixteenth Amendment; was doing a large chain grocery business; had grown from incorporation to a large business on its own profits; that the surplus was not in excess of the needs of the business and that the purpose in retaining earnings was to continue growth and expansion and for proper corporate purposes.

(2) Is Section 104 of the Revenue Act of 1928 unconstitutional (a) as imposing a frightful penalty to accomplish thereby what Congress may not regulate directly, namely to compel private corporations to pay dividends in order to create a basis for taxation; (b) as violating the Fifth Amendment in that it specifies no standards of any kind for the guidance either of the taxpayer or the Commissioner and is arbitrary, oppressive and confiscatory; (c) as violating Article I, Sec. 1, and Article I, Section VIII, par. 18, in that it permits the Commissioner alone to determine by his own standards upon what corporations to assess the penalty; and (d) as being nothing less than a tax on a purpose, hence void.

The Statute and Regulations Involved.

The statute is printed for ready reference under Point I hereof. Earlier sections of the same law, showing its

development, and copies of reports and debates in Congress are set forth in the appendix, *infra*, pp. 77 to 123.

Summary of Argument.

Section 104 of the Revenue Act of 1928 imposes a penalty of fifty per centum of the net income upon corporations formed or availed of for the purpose of preventing the imposition of the surtax on its stockholders and provides that the fact that the gains and profits are permitted to accumulate beyond the reasonable needs of the business, shall be *prima facie* evidence of a purpose to escape the surtax.

Respondent, before the Board, offered in evidence facts and schedules showing the entire history and development of the business, and its directors testified their policy had always been to conserve all possible resources and grow and expand on earnings; that the purpose of the corporation was to continue growth and expansion; that in the year under review they were negotiating for the purchase of existing chains of stores; their business was not fully developed; that they had need in the business of all the earnings, and, in the year under review, all assets depreciated enormously, far exceeding net income reported.

The Company had over 2,300 employees, whose wages aggregated over $3,000,000; purchases $20,000,000; sales $25,000,000; rents of $1,000,000; surplus of nearly $9,000,000, which had depreciated about 25% in the year.

The Board of Tax Appeals, disregarding the sworn testimony of the directors, found from the book figures alone that the corporation was availed of for the forbidden purpose, holding that it had not overcome the statutory presumption.

The Circuit Court of Appeals held that there was no evidence, substantial or otherwise, to support the findings of the Board.

Before the Circuit Court of Appeals, taxpayer contended and here contends that the object of Section 104 was to prevent the formation of holding companies for the purpose of tax evasion and that said section does not apply to corporations engaged in a *bona fide* mercantile and manufacturing business having needs for large capital which grow and expand on their earnings and intend to continue growth.

Respondent contended below and here contends that as applied to corporations in *bona fide* business, Section 104 is unconstitutional, in that it is a mere penalty whose purpose is to regulate and control dividend policies of private corporations formed under the laws of the States, in order to create income subject to the surtaxes; further, that said section is nothing less than a tax on a purpose, and, as such, is void; moreover, that said section violates the Fifth Amendment in that no standards are set forth for the guidance either of directors or the Commissioner as to the amount of reserves that may be carried for obsolescence, depreciation and other like business requirements. There is nothing to indicate what dividends must be paid to avoid its imposition and it reposes arbitrary power in the Commissioner and is, hence, oppressive and confiscatory.

It is further contended that said statute is void as reposing legislative power in the Commissioner, enabling him to determine, by standards that he alone sets up, upon what corporations the penalty shall be levied.

This is the first case that has come before the courts where an attempt was made to assess this penalty upon a corporation engaged in active business, formed before the

adoption of the Sixteenth Amendment and which was expanded on its own earnings.

It is submitted that no other decision with respect to the facts properly could be made than that made in the Court below, and that the constitutional questions involved are so serious to corporations engaged in *bona fide* business that this Court should examine them and hold the law invalid.

Statement.

History of the Business: Its Origin and Subsequent Course.

(A) Origin of the Business.

Henry Kohl came to this country in 1887 from Germany a penniless immigrant boy and secured employment in a grocery store in Brooklyn. In 1891 having saved $217.00 he bought a grocery store in Jersey City. By 1900 he had purchased two stores. He lived in the back of the store, cooked his own meals and, as he expressed it, lived "like all poor devils do" (R. 63).

By 1906 he had three stores and formed Henry Kohl Company, a New Jersey corporation.

In 1908 that Company, which did business on credit, lost $4,000.00. Kohl realized he could not continue along the usual lines. After long and serious thought he conceived the idea of establishing cash and carry stores of moderate size, cleanly kept, with no deliveries and no telephones, with goods prominently displayed and conveniently disposed for the work of the employees, and opened one store as an experiment under the name National Grocery Company, doing business in an entirely new way (R. 64). After about six months this store commenced to do a great deal

of business. He later opened two additional stores and incorporated the business into National Grocery Company in 1908 (R. 65). In 1911 he merged the National Grocery Company and Henry Kohl Company under the name of the former, and after the merger had 57 stores. He financed his expansion entirely on his profits (R. 65).

(B) Difficulties in Financing Business.

From the opening of the first store Kohl encountered difficulty in financing his business. He commenced practically without capital; he had practically no credit. He attempted, at one time, to raise capital by issuing stock, but his attempt was unsuccessful. He early realized that in his case success could only be attained by leaving in the business all his gains and profits except sufficient for his bare living.

(C) All Expansions Were on Accumulated Earnings.

From 1908 forward the growth of the Company is graphically shown by the continuous balance sheet (Ex. 6, R. 136), the statement of the stores operated, gross sales and net profits (Ex. 7, R. 138), the amount of Kohl's salary, income taxes paid, and net profits (Ex. 4, R. 133). These exhibits show a steady growth year by year. This was due to hard work, capable management, willingness of Kohl to live simply to attain success, and a consistent policy of ploughing the earnings back into the business for continued growth and expansion.

National Grocery Company never sold any stocks or bonds. In the early days Mr. Kohl tried to sell stock or bonds in Wall Street,

> "but I was not welcome there and was unable to raise any money by that kind of financing. As time

went on and by the method of keeping all of my profits in the business, except what were necessary for my bare living expenses, 'I was independent and did not want to sell it' " (stock) (R. 65-66).

Mr. Kohl never put anything into the business by way of securities or contributions to the capital from the time the business was incorporated (R. 83).

This policy and this management have resulted in gross sales increasing from $181,000.00 in 1908 to over $25,000,000.00 for the year under review (R. 138), and the net profits increased from $4,584.39 in 1908 to the peak profit of $786,466.98 for the year under review (per the books) (Ex. 7, R. 138).

The purpose of the management has always been to keep on growing through the opening of additional stores, or through the acquisition of an existing chain of stores (R. 67, 69, 70, 77, 78, 79, 80).

Net earnings, paid for the warehouses, stables, garages, stores and inventory of merchandise (Exs. 16, 17, 18, R. 148-152).

(D) Plans for Continuous Expansion.

Miss Mullins, treasurer of the Company, testified that throughout his business experience Mr. Kohl planned continually to expand. When he had one store he promised her he would one day have ten stores. After he had ten he planned to have one hundred. When he had two hundred stores he planned to have one thousand. When he got up to six or eight hundred stores he planned to have two thousand stores (R. 78).

The bakery and warehouse were erected to take care of between fifteen hundred and two thousand stores (R. 78).

The number of stores expanded from 3 to 815 by the slow steady method of opening stores one after the other.

It would take about $3,500,000 capital to finance 700 additional stores (R. 68, 69).

For several years prior to 1930 Mr. Kohl had been negotiating to acquire one or more existing chains of stores within territory that could be served from the central unit of the Company.

Mr. Field, President of the Commercial Trust Company of New Jersey, and former President of the New Jersey Bankers' Association, testified:

> "A company like the National Grocery Company cannot expand unless it covers the total territory that can be covered by a motor truck from its central unit, and to get the full advantage of a chain store business they must cover that territory" (R. 87).

Mr. Field said:

> "Mr. Kohl has talked to me once or twice about wanting to purchase other chains of stores, if the opportunity offered. On his behalf, I approached one chain of stores two or three times to see if it was in the market for sale so that Mr. Kohl might buy it, but they showed no evidence of wanting to sell. This was several years ago. I do not recall how long ago" (R. 89).

The National Grocery stores in the year under review were located in Staten Island, the Northern part of New Jersey and Rockland County, New York, all on the west side of the Hudson River and all within trucking distance of the central warehouse in Jersey City. Across the river, in New York, Brooklyn, Long Island and Westchester County, all within trucking distance of Jersey City, was a densely populated area in which there were no National Grocery stores. They planned to enter this area (R. 69).

Miss Mullins testified that in 1929 and 1930 Mr. Kohl discussed with her the purchase of another chain of stores, one being located in Paterson, New Jersey. In 1930 there was under contemplation the expansion of the business and the opening of a chain of stores in New York City. Their plan of expansion was to cover the area within trucking radius of the central warehouse. They made numerous surveys with the idea of opening a chain of stores in New York. Miss Mullins said:

> "That has been constantly in the minds of Mr. Kohl and myself for many years. Every time anybody came to New York and saw the business that was there, and we were so close to it, we hoped some day to get that business. Every time our store superintendents or real estate department made investigations we found the rents were prohibitive for our type of business. It is a matter of cost and expense. We have the ability to finance and have maintained our ability to finance expansion as, if and when the time is ripe, either by buying an existing chain or by buying new stores. That has been Mr. Kohl's purpose in keeping the surplus in his business" (R. 80).

In 1929 and 1930 Mr. Bohack of the H. C. Bohack Company in Brooklyn was alive, and offered to sell Mr. Kohl his chain of five or six hundred stores.

Kohl testified:

> "We had made a careful survey of this business to see if it was profitable for us to buy it, but while the negotiations were pending Mr. Bohack became ill and died. These negotiations were resumed as late as 1935. The Bohack Company is a large concern—five or six million dollars (R. 70).

(E) Safety and Expansion of the Business the Dominant Purpose.

When asked why he kept all the earnings in the business instead of drawing them out, Mr. Kohl testified that he needed them in the business; and that he never had any too much money. He told of his need for large surplus for use in obtaining discounts; for purchasing in large quantities; for use in time of war and scarcity of supplies; for expansion of the business; all of which tended toward security and growth of the business. He said that it had been the policy of the business from the beginning to let profits accumulate for the benefit of the business. He said that if he had adopted a different policy in the good years from 1920 to 1930, he did not believe that the business would have survived the depression so well, and he added that he believed that those concerns that did pay out their earnings in the good years have gone (R. 73).

Miss Mullins testified that it had been Mr. Kohl's opinion from the foundation of the business that he would make more money reinvesting his money in grocery stores than in any other type of investment (R. 77).

The continuous balance sheet (R. 136) shows that from the foundation of the business surplus moneys were invested in stocks and bonds. The amount stood at $750.00 from 1908 to 1910. The book value of the stocks in the portfolio in the year under review was $2,676,061.47, bonds $313,391.27, but in the year under review these securities depreciated in value by over $943,517.42 (R. 146).

(F) Extent to Which the Business Had Grown by 1930.

The policy of thrift adopted by the management showed these results by 1930:

The Company operated 815 stores, an increase of 16 over the preceding year (R. 138); it had 2,332 employees, who were paid wages of $3,132,891.99 (Ex. 9, R. 140); its purchases of goods aggregated $19,993,937.83; it paid rents of $929,918.70, and it earned by discounting its bills payable the sum of $493,719.24 (Ex. 10, R. 141).

Mr. Kohl drew in salary that year $2,000.00 per week, or $104,000.00, and the Company paid Federal income taxes of $103,616.60. Mr. Kohl's personal income tax that year was $11,140.84. The Company paid municipal and state taxes of $36,371.87 (Ex. 4, R. 133).

Miss Mullins testified that in the year 1930 there was a general decline in the market value of all assets, "including our inventory of merchandise, our inventory of groceries, and our inventory of securities" (R. 81). The Company's net worth declined in that one year by over $2,000,000.00.

We show under Point IV-B hereof the extent of this depreciation.

POINT I.

The Statute.

Revenue Act of 1928, c. 852, 45 Stat. 791:

> "SEC. 104. ACCUMULATION OF SURPLUS TO EVADE SURTAXES.
>
> "(a) If any corporation, however created or organized, is formed or availed of for the purpose of preventing the imposition of the surtax upon its shareholders through the medium of permitting its gains and profits to accumulate instead of being divided or distributed, there shall be levied, col-

lected, and paid for each taxable year upon the net income of such corporation a tax equal to 50 per centum of the amount thereof, which shall be in addition to the tax imposed by section 13 and shall be computed, collected, and paid upon the same basis and in the same manner, and subject to the same provisions of law, including penalties, as that tax.

"(b) The fact that any corporation is a mere holding or investment company, or that the gains or profits are permitted to accumulate beyond the reasonable needs of the business, shall be prima facie evidence of a purpose to escape the surtax.

"(c) As used in this section the term 'net income' means the net income as defined in section 21, increased by the sum of the amount of the dividend deduction allowed under section 23 (p) and the amount of the interest on obligations of the United States issued after September 1, 1917, which would be subject to tax in whole or in part in the hands of an individual owner."

It will be observed that the provisions of the section apply, (a) where a corporation is formed for the prohibited purpose, or (b) is *availed of* for such purpose.

POINT II.

National Grocery Company was not formed for the forbidden purpose.

The corporation was formed in 1908 to conduct a grocery business (R. 126), when its capital and surplus was $20,943.46 (Ex. 6, R. 136). It has continued in the grocery business ever since (R. 136). When the Sixteenth Amend-

ment was adopted it had 81 stores, and at the end of the year under review it had 815 stores (R. 138). Under such circumstances it must be conceded that the company was not formed for the forbidden purpose and, accordingly, neither the Commissioner, the Board of Tax Appeals, nor the Court below found that the company was formed for the forbidden purpose.

POINT III.

National Grocery Company was not availed of for the purpose of preventing the imposition of the surtax upon its shareholders within the meaning of the Statute.

(A) Imposition of this penal tax is tantamount to a finding that the company was a party to an attempt to cheat and defraud the Government out of surtaxes, or was intentionally used for such purpose.

The presumption which favors the honesty of the taxpayer requires proof on the part of the Government which excludes any reasonable possibility of a proper, lawful purpose, before an intention to cheat or aid in cheating the Government by preventing the imposition of surtaxes upon its shareholders can be claimed.

> "Fraud is not presumed either as a matter of law or fact, unless under circumstances not fairly susceptible of any other interpretation." Justice Story—*Tucker* v. *Moreland,* 10 Pet. 58, 78.
>
> *Harrison* v. *Vose,* 9 How., 372, 378.

The Government is aided in sustaining this burden by subsection B of section 104, which provides that the fact

"that the gains or profits are permitted to accumulate beyond the reasonable needs of the business, shall be prima facie evidence of a purpose to escape the surtax." Even proof of such fact does not relieve the Government of its burden of proof to establish the forbidden purpose.

(B) The statutory presumption only aids the Government where the fact is established that the corporation has permitted its gains or profits to accumulate beyond the reasonable needs of the business.

Clearly the burden is upon the Government to establish at the outset by competent evidence that there was an accumulation of gains or profits beyond the reasonable needs of the business.

In the case at bar the evidence which the Commissioner introduced before the Board was as follows:

EXHIBIT 5. An analysis of the surplus of the respondent from 1913 to 1931, inclusive (R. 134), introduced as petitioner's exhibit by consent (R. 56), and also income tax returns of Henry Kohl from 1922 to 1930, and income tax return of National Grocery Company for the year under review (R. 99, Par. 3).

Mr. Smith, counsel for the Commissioner, said on the trial:

> "Our case will be found chiefly in the schedules of the operations of the National Grocery Company during the year in question and previous years. From that we will ask the Board to make its deductions" (R. 48, l. 40).
>
> "The law presumes, in the absence of evidence to the contrary, that the business transactions of every man are done in good faith and for an honest purpose; and anyone who alleges that such acts are done in bad faith, or for a dishonest and fraudulent

purpose takes upon himself the business of showing the same."

Jones vs. *Simpson*, 116 U. S., 609;
U. S. Industrial Alcohol Co. vs. *Distillers Company of America*, 89 N. J. Eq., 177.

"Fraud is not presumed either as a matter of law or fact, unless under circumstances not fairly susceptible of any other interpretation."

Tucker vs. *Moreland*, 10 Pet., 78.

There was no proof whatever offered by the Commissioner that the gains or profits of the respondent were accumulated beyond the reasonable needs of its business as those needs were before the Board of Directors in their management and guidance of such business. Not a witness testified that the surplus was beyond such needs.

The greatest length the Government goes in its brief before the Court is to contend that from the mere fact that the taxpayer's books show it had a large surplus, part of which was invested in a diversified list of securities, and that in the year under review the principal stockholder borrowed on notes from the corporation $140,000, and in earlier years had borrowed $470,000 additional, an inference may be drawn that the surplus was so large as to be beyond the reasonable needs of the business. We contend no such inference may be drawn.

(C) Establishment of the fact that gains or profits are beyond the reasonable needs of the business is only prima facie evidence of the purpose.

Not until the Commissioner has proved by competent evidence that gains or profits have been allowed to accu-

mulate beyond the reasonable needs of the business does the presumption arise of the existence of the prohibited purpose.

This is clear from a reading of the rather remarkable 104(b) section. Though the Government produce evidence that the accumulation was beyond the reasonable needs of the business, the sole result would be no more than to compel the taxpayer to disclose the facts which motivated its conduct.

Assuming, but not admitting, that there existed sufficient evidence on petitioner's case to disclose the facts, let us examine the proofs to discover such facts—

(D) Respondent's proofs of its actual purposes in retaining earnings.

Respondent in disclosing the facts called as witnesses Henry Kohl, its president, Miss Anna L. Mullins who had been associated with Mr. Kohl in business for thirty years and who was treasurer of the company, Mr. William J. Field, president of the Commercial Trust Company of New Jersey, in which respondent did most of its banking business, and Mr. Frank C. Ferguson, president of the Hudson County National Bank and Chairman of the Port of New York Authority.

From their sworn testimony we find that respondent, ever since the opening of its first store, has pursued one course of conduct, to wit, that of plowing back its earnings into the business with the view of growth, financially and in numbers of stores; that this course of conduct never changed; that the purpose, or object in view, was constant; that such purpose extended prior to 1930 and throughout 1930.

Mr. Kohl:

"I kept all the earnings in the business because I needed them in the business—always needed them in the business. I never had any too much money in my business. That was my judgment. • • • Even with all the capital that the company had we had to borrow money from the banks occasionally as it was needed. We needed it to buy butter and eggs and put them in storage, and to buy merchandise when it was the right time to buy. Frequently you need more money than you have got. It takes all of the money we have got to swing that" (R. 72).

"It has been the habit with us to keep in the business every possible dollar, and let that accumulate for the benefit of the business. I think it is good business judgment and I guess everybody else does. The bankers tell you that. If we had adopted a different policy and in the good years from 1920 to 1930 had drawn out of the business a large part of our profits, I do not think we would have been able to withstand the effect of this depression the way we have. I think those concerns who did do that have gone" (R. 73).

Miss Mullins:

"It is my opinion, as Treasurer of the Company, that in the year 1930 the surplus was not in excess of the reasonable needs of the business, and is not today, although conditions are different. In order to finance the purchase of $20,000,000 worth of merchandise and pay a million dollars in rents per annum, the Company required its surplus, in my opinion. There were times even at that when we were short of cash, and had to borrow temporarily from the banks in order to pay for incoming merchandise" (R. 79).

Mr. Field:

> "The accumulation of these earnings in the past years has enabled the National Grocery Company to buy advantageously and always to have a proper working capital, although in several years leading up to 1930 they found it necessary to borrow money in addition to the money that was available. Their accumulation of the surplus, invested in securities, enabled them to show a proper credit statement and hence their ability to borrow whenever they wanted, at low rates of interest" (R. 88).

He also said:

> "I don't think it was in excess of reasonable requirements and reasonable safety of the business" (R. 86).

Mr. Ferguson:

> "In my opinion for the year ending January 31, 1931, the surplus of the corporation was not in excess of the reasonable needs of the business. In my opinion it was good sound business practice for the company in that year not to declare any dividends, because in view of the times it was important to conserve all cash resources" (R. 93).

(E) The purpose of the Company in investing surplus funds in securities.

The purpose of the management in putting surplus cash in a miscellaneous list of securities was:

Kohl:

> "To invest that money so that when we would need it we would have it. All corporations do that more or less. * * * We wanted to use it all the

time. It was invested because we wanted to have the cash on hand. And those were the days there was very little investment. We had to have the money ready. What will you do with it if you don't invest it? * * * It was part of our business. We carried that money, of course, principally to have the money on hand and get something for it. At the banks you would only get 2 per cent at that time. Of course, you don't get anything now. So we bought some stocks and bonds which we could turn over. You know, you can turn that stuff over in the morning, in a couple of hours, and you have your money if you want it" (R. 75, 76).

"In the early years when we went to the banks to borrow money I had plenty of difficulty in getting credit. I found from actual experience that having those securities in the statement of the National Grocery Company enabled the Company to get credit at low rates where we had been unable to do that in the earlier years" (R. 76).

The Solicitor General in his brief (p. 3) concedes that for a long time respondent had invested its cash in securities with the thought in mind of realizing cash therefrom with the purpose of expanding its grocery stores at any time desired.

(F) Flat denial of the prohibited purpose.

Moreover, respondent affirmatively proved that National Grocery Company was not availed of to avoid taxes. Mr. Kohl testified:

"I did not refrain from paying dividends in the National Grocery Company in 1930 in order to avoid the payment of any government taxes. I have never done that" (R. 75).

(G) All taxes could have been avoided lawfully, had tax avoidance been in the minds of the management.

If there had been any intention on the part of the management of this business to avoid taxes, all it had to do was to dump on the market some of its bank stocks and sell them for what they would bring. Thus a deductible loss under the Revenue Act could have been established sufficient to wipe out all the net profits reported. By that method the Company would have saved income taxes of $103,616.60 which the Company paid, as well as avoided all questions under Section 104.

All of the above mentioned testimony of the officers, who were in charge of the management of this business, was wholly disregarded by the majority members of the Board of Tax Appeals. The opinion of the majority did not even mention the testimony as to purpose given by Mr. Kohl and Miss Mullins. Their opinion had nothing to support it but the statutory presumption and, as we shall show below, that passed out of the case when the taxpayer offered its proofs.

Moreover, the proofs of the taxpayer were in entire harmony with the exhibits which showed what assets and liabilities the business had, its growth and development, and its size.

Every bit of growth, every expansion the business had made from its humble origin had been made on accumulated earnings. The Company had never been financed or expanded through borrowed money. It never borrowed money except on short term borrowings. The Company never sold any stock or bonds to the public. All the expansions of the business had been made out of earnings (R. 77).

(H) In view of the foregoing the presumption is out of the case.

The Commissioner did not call a single witness to dispute or deny any of the above testimony.

In *United Business Corporation* v. *Commissioner, supra,* Judge Hand said:

> "A statute which stands on the footing of the participants' state of mind may need the support of presumption, indeed be practically unenforceable without it, but the test remains the state of mind itself, and the presumption does no more than make the taxpayer show his hand. *Pariso* v. *Towse,* 45 Fed. (2d) 962; *Alpine Forwarding Co.* v. *Pennsylvania Railroad Co.,* 60 Fed. (2d) 734."

In the recent case of *New York Life Insurance Co.* v. *Gamer,* 82 Sup. Ct. Rep. Adv. Opinions 480, 483 (decided February 14, 1938), Mr. Justice Butler said:

> "* * * presumption is not evidence and ceases upon the introduction of substantial proof to the contrary. Thayer, Preliminary Treatise on Evidence, p. 346; Mobile, J. & K. C. R. Co. *v.* Turnipseed, 219 U. S. 35, 43; Western & A. R. Co. *v.* Henderson, 279 U. S. 639, 642, 644; Heiner *v.* Donnan, 285 U. S. 312, 329; Atlantic Coast Line R. Co. *v.* Ford, 287 U. S. 502, 506; Del Vecchio *v.* Bowers, 296 U. S. 280, 286; Nichols *v.* New York L. Ins. Co., 88 Mont. 132, 139. * * *
>
> "* * * presumption is not evidence and may not be given weight as evidence. Despiau *v.* United States Casualty Co. (C. C. A. 1st), 89 F. (2d) 43, 44; Jefferson Standard L. Ins. Co. *v.* Clemmer (C. C. A. 4th) 79 F. (2d) 724, 730, 103 A. L. R. 171; Travelers Ins. Co. *v.* Wilkes (C. C. A. 5th) 76 F. (2d) 701, 705; Fidelity & C. Co. *v.* Driver (C. C. A. 5th) 79 F. (2d)

713, 714; Frankel *v.* New York L. Ins. Co. (C. C. A. 10th) 51 F. (2d) 933, 935; Ocean Acci. & G. Corp. *v.* Schachner (C. C. A. 7th) 70 F. (2d) 28, 31. But see: New York L. Ins. Co. *v.* Ross (C. C. A. 6th) 30 F. (2d) 80; Tschudi *v.* Metropolitan L. Ins. Co. (C. C. A. 8th) 72 F. (2d) 306, 308, 310; Nichols *v.* New York L. Ins. Co., 88 Mont. 132."

Del Vechio v. *Bowers,* 296 U. S. 280, 286;
Metropolitan Life Ins. Co. v. *Armstrong,* 85 F. (2d) 187, 195.

(I) Fallacy of argument for the Commissioner.

The Solicitor General contends in his brief that respondent's accumulations were not needed to acquire new stores, were not needed in the business, and were not needed because of the depreciation in the value of securities or inventory.

No witness testified to any of these contentions. They are nothing but contentions.

When the Solicitor General argues that the Circuit Court of Appeals overlooked or disregarded an array of facts and circumstances which, "together with proper inferences to be drawn therefrom, not only discount the testimony it relied upon, but amply justify the findings of the Board," he asks the Court in effect to displace evidence with conjecture, surmise and inference.

We submit that the inferences which can properly be drawn from an examination of the balance sheet are very limited. The balance sheets on their face show the relation between capital and surplus, assets and liabilities. One cannnot infer from looking at a statement showing the number of stores in operation year by year anything about the location of such stores. One cannot tell from

looking at the statements in evidence whether the management was planning to expand the business in Brooklyn, the Borough of Manhattan, or the Bronx or Westchester County.

The *factum probandum* in this case is purpose of the management. That cannot be inferred from a mere examination of books. That can only come from the minds of the directors and officers. When directors testify that their purpose is one thing and their actions show their purpose is something different, they may be disbelieved. Here, however, the course of the conduct of this business from its origin shows that the motivating purpose throughout has been growth and expansion on earnings. The management under oath revealed their purposes for the future, their plans and the reason for them.

The Solicitor General argues that because the Company could have paid dividends and did not, therefore its purpose was to evade the surtaxes. Not so!

The fact that the Company had on deposit in bank $1,400,000.00 at the end of the year does show an *ability* to pay a dividend. It does not, however, prove that the reason a dividend was not paid was for a fraudulent purpose. The attitude of the Government is that if the Company could pay a dividend and did not, *ipso facto* the forbidden purpose was proved. The statute does not say so.

This argument would not only cast the burden of proof on the taxpayer, (which the Board of Tax Appeals did (R. 22, 23)), but also it would make it liable for the penalty.

The purpose to evade surtaxes must be shown by clear and convincing proof to have been the *sole* aim and object of the directors before this highly penal tax can be assessed.

The exercise of directors' discretion turns on business

expediency and not on strict necessity or rules of law—not on the whims or predilections of the Commissioner.*

Obviously no two situations are alike and the views of business men must be as different as the men themselves. Some are bold and venturesome. Others are conservative and cautious. Some look to the future. Others only to the immediate. Until our form of government changes to strip from business men the right and discretion to manage the affairs of corporations with what is commonly called "horse sense", neither the courts nor government officials will have the right or power to displace the exercise of directors' discretion, though they have been guided by their personal views of expediency.

If, therefore, the act of directors in retaining earnings and withholding dividends is consistent with their view of business expediency, if a purpose or aim foreign to the accomplishment of the business objects of the corporation is not clearly and convincingly shown to have shaped their acts, the Commissioner must be held to be without power to set aside their acts and impose the penalty tax of Section 104 as for a guilty and wrongful evasion of surtaxes.

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* Dewing, in The Financial Policy of Corporations, 1934, page 606, says:

> "Many and varied considerations tend to influence the directors in determining the proportion of the total net surplus that may expediently be distributed among the shareholders and the proportion that should be kept in the business. This question is not one of the theory of accounts or of business law or even of universally applicable principles. It is purely one of individual business expediency."

At page 615, Dewing says:

> "The dividend disbursement is essentially a problem of business expediency and can be treated only in this light."

See Chapter 3, page 656, on The Practical Expediency of Dividend Disbursements.

(J) Respondent was no "pocketbook" for Kohl.

The Solicitor General's argument that Kohl by borrowing from the company used respondent as a convenient "pocketbook" for tax avoidance is refuted by several facts:

(1) For credit purposes the surplus was maintained intact. The cash was reduced, but the notes receivable account was increased by an equal amount (Ex. 6, R. 136).

(2) Such notes receivable were regarded as a good asset, collectable on demand (Field, R. 92).

(3) The Commissioner conceded them good by including the amount in his calculation of the surplus year by year (Ex. 5, R. 134).

(4) Every loan was entered on the books and evidenced by notes signed by Kohl (R. 81, 84).

(5) For the year ended Jan. 31, 1928 when Kohl's notes aggregated $424,100 (Ex. 6, R. 136) the Commissioner ruled (on Oct. 13, 1930, R. 125) that respondent was not subject to the penalty of Secs. 220, Act of 1926 and 104 of Act of 1928.

(6) Kohl repaid all the notes which he gave respondent during the year in question, and others besides as follows:

March 17, 1931	$60,000	
Aug. 25, 1932	$65,000	
May 24, 1933	$86,000	R. 142

The first of these payments was before the tax return was filed. The others were before the 60 day notice was mailed April 25, 1934 (Ex. 11, R. 142).

The corporate records show that subsequent to the date of the trial every loan with interest has been paid in full.

(7) If the Commissioner had honestly believed Kohl was using the Company as his "pocketbook" why did he not assess Kohl for taxes on the loans as though they were in fact dividends? He knew no fraud was involved in this matter in any respect whatsoever.

The element of loans by a corporation to a stockholder is not in any sense a fair test of a purpose to evade taxes.

Suppose a corporation is in the banking business, all of its stock being owned by one man. The business of a bank is to loan money. If the bank loaned money to its sole stockholder against his note, could it be said that because he borrowed from the bank which he owned, that thereby an intention was shown to use the corporation to evade taxes?

These loans were not handled in a way indicating tax avoidance. The manner they were handled shows clearly an intention to keep the money in the Corporation in accordance with the historic policy of expansion and business safety that had persisted for a quarter of a century.

In *United States* vs. *Tway Coal Sales Co.*, 75 Fed. (2d) 336, the taxpayer sued for the recovery of taxes paid after an assessment under Section 220 of the former law. Judgment for the taxpayer in the District Court was affirmed by the Circuit Court of Appeals (Sixth Circuit), despite the fact that the sole stockholder had borrowed larger sums both relatively and actually from his corporation than Kohl did from National Grocery Company.

Henry Kohl had learned through his early years of privation, and even starvation, the necessity of thrift. He

knew that National Grocery Company could not pay out its surplus and have it too. The Company could not have grown and expanded, as it did, if it had paid out its earnings in dividends.

This Corporation did no more than conduct its business according to the principles of thrift taught by Benjamin Franklin two centuries ago. An older precedent is the story of Joseph and Pharaoh, of the seven fat years and seven lean years. Genesis, Ch. 41. On such principles the outstanding business enterprises of this nation have been developed.

Is section 104 to be the death-knell of all progress except on borrowed money? If so, bankruptcy will catch all business when pay day comes in times of adversity.

POINT IV.

The words "gains and profits" as used in the statute mean actual, rather than taxable gains and profits.

No Court has so far determined the meaning of the words "gains and profits" as used in Section 104.

A.

The Commissioner and the Board of Tax Appeals below obviously considered the words "gains and profits," as used in Section 104, to mean taxable gains and profits, and in this, we submit, they erred.

> "It is undoubtedly the duty of the Court to ascertain the meaning of the legislature from the words used in the statute, and the subject matter to which it relates; and to restrain its operation within nar-

rower limits than its words import if the court are satisfied that the literal meaning of its language would extend to cases which the legislature never designed to embrace in it."

Chief Justice Taney in *Brewer* vs. *Blougher*, 39 U. S. 14 Pet. 178, 198;
Petri vs. *Commercial National Bank*, 142 U. S. 644; 650;
McKee vs. *U. S.*, 164 U. S. 287, 293.

There are at least three kinds of gains and profits: (1) Gains and profits as they are entered on the books of the corporation in its business operations; (2) actual gains and profits determined by market values of the assets of the corporation, and (3) gains and profits as determined by the provisions of the Revenue Acts and the regulations of the Commissioner of Internal Revenue.

The Commissioner and the Board paid no attention whatsoever to the uncontradicted proofs of the drastic declines in value of securities, inventories and real estate suffered by the respondent in the year under review. The extent of this depreciation is shown under Point B hereof. It is sufficient here to state that although respondent in its income tax return showed for the year under review it had total net income of $955,532.11, actually in the same year, because of the terrific depreciation in that, the first year of the depression, the Company's net worth shrank in value over $2,000,000.00.

Section 104(a) imposes the tax where a corporation permits its "gains and profits" to accumulate beyond the reasonable needs of the business. There must be both gains *and* profits before the tax falls.

Section 104 is the only place in the income tax law where the words "gains and profits" occur. All other sections of the income tax law impose taxes on income.

That "taxable" gains and profits could not have been meant by the Congress in enacting Section 104 would seem to be indicated by the fact that what are taxable gains and deductible losses for tax purposes is determined from time to time in the Revenue Acts enacted by the Congress. Surely a definition as variable as a March wind was not intended.

For instance, under the Revenue Act of 1934, Congress inserted a provision, Section 117(d), that if a corporation sells capital assets and incurs a net loss, only $2,000.00 of the amount thereof may be deducted from gross profits. Therefore, if a corporation, subject to the application of Section 102 of the 1934 Act, should sell, during a taxable year, stocks and bonds and have an actual loss therein of $2,000,000.00, and during the same year sell an apartment house and realize a profit thereon of $1,000,000.00, only $2,000.00 of the $1,000,000.00 net loss could be deducted. If the corporation also received an income of $500,000.00 from investments, it would have "taxable" gains and profits of $498,000.00, notwithstanding an actual loss of $500,000.00 from operations during the year.

If the words "gains and profits" as used in the statute are to be construed to mean taxable gains and profits (the method used by the Board below), the result might well amount to a confiscation of all the remaining assets of a corporation; whereas if actual gains and profits are considered no such devastating result would follow.

The words "gains and profits" as used in Section 104 are first found in the Tariff Act of October 3, 1913 (see

Appendix, p. 77); and they have been carried forward in each amendment passed since that time.

The only clue to the meaning of "gains and profits" as used in the Tariff Act of 1913, is contained in the words,

> "the taxable income of any individual shall embrace the share to which he would be entitled of the gains and profits, if divided or distributed or not, of all corporations * * * however created or organized, formed or fraudulently availed of for the purpose of preventing the imposition of such tax through the medium of permitting such gains and profits to accumulate" etc. (Appendix, p. 78).

Gains and profits are thus defined to mean the stockholder's share of the corporation's gains and profits for the year, *i. e.*—that portion which a corporation might properly distribute, or which a minority shareholder might by a court action compel to be distributed.

Suppose a corporation in the investment business with a capital of $2,000,000.00 in 1928 had invested $1,000,000.00 in an apartment house and $1,000,000.00 in bank stocks. Suppose that in 1930 the corporation had a net income from rents and dividends on the bank stocks amounting to $120,000.00, or six per cent on the capital. Suppose, furthermore, that in the depression the value of the apartment house had declined to $250,000.00, and the bank stocks to $250,000.00, the net worth of the assets of the company being $500,000.00. In such circumstances the capital of the business would actually be impaired by a million and a half, but the Commissioner of Internal Revenue would disregard the depreciation, as he did in the case under review, for he would contend that he is only concerned with losses estab-

lished through sales, and that the corporation having a net income of $120,000.00 and having declared no dividends is subject to the penalty of 50 per cent of $120,000.00, plus the normal tax on $120,000.00.

The New Jersey Corporation Act provides:

> "30. The directors of a corporation shall not make dividends except from its surplus, or from the net profits arising from the business of such corporation, nor shall it divide, withdraw, or in any way pay to the stockholders or any of them, any part of the capital stock of such corporation, or reduce its capital stock except as authorized by law; in case of any wilful or negligent violation of the provisions of this section, the directors under whose administration the same may have happened, except those who may have caused their dissent therefrom to be entered at large upon the minutes of such directors at the time, or who not then being present, shall have caused their dissent therefrom to be so entered upon learning of such action, shall jointly and severally be liable at any time within six years after paying such dividend, to the stockholders of such corporation, severally and respectively, to the full amount of any loss sustained by such stockholders, or in case of insolvency to the corporation or its receiver to the full amount of any loss sustained by the corporation, by reason of such withdrawal, division, or reduction."
>
> P. L. 1904, Chap. 143, page 275.

Similar laws are in effect in most states. See *Corpus Juris*, Vol. 14, page 800.

Since Section 104 operates on the purposes, *i. e.*, mental processes of the board of directors of corporations, it is essential to consider the matters that necessarily guide

directors when they come to consider the declaration of dividends.

In times of depression directors necessarily must consider first, whether the assets of the corporation are actually worth book value; second, the effect on the business of a distribution of cash to the stockholders, and third, how long is the depression going to last, how far will it run, and what effect will it have on the business. These are only a few of the questions that are considered by careful business management.

Would any sensible director disregard a decline in market value of securities and other assets for the reason that the loss was not presently deductible in the computation of taxable net income?

It is a well known fact that during the depression the National Government, as well as State Governments, closed many banks because their securities had depreciated in market value to a point where their capital was excessively impaired, although the loss had not been actually realized in the sense that the securities had been sold.

How can directors properly perform their fiduciary obligation to stockholders if they must disregard actual business conditions and base their judgment solely on the provisions of the Revenue Acts, which are changed every year or so by the Congress?

Furthermore, this is a penal statute and as such should be strictly construed. It should be construed most favorably to the taxpayer and against the Government.

Gould vs. *Gould*, 245 U. S. 151;
Crocker vs. *Malley*, 249 U. S. 233;
United States vs. *Field*, 255 U. S. 262;

Smietanko vs. *First Trust Bk.*, 257 U. S. 606;
Schwab vs. *Doyle*, 258 U. S. 534;
United States vs. *Merriam*, 263 U. S. 188;
Hecht vs. *Malley*, 265 U. S. 156;
Reinecke vs. *Northern T. Co.*, 278 U. S. 348;
Aluminum Castings Co. vs. *Routzahn*, 282 U. S. 100;
Old Colony vs. *Commissioner*, 284 U. S. 561.

Certainly Congress never intended the penalty of 50 per cent to fall on a corporation whose net worth had an enormous shrinkage in the taxable year. It is essential to give their full meaning to the three words "gains and profits."

Congress did not use the word "gains" as synonymous with income or profits, for had that been its intention it would have used the words "income or profits." In using the word "gains" it undoubtedly contemplated unrealized capital increases or accession in the net worth of the business.

We submit that the proper construction of the words "gains and profits" is "income", plus increase in net worth. Undistributed net income is included in net worth necessarily. Where there is a terrific decrease in net worth how can there be any gains?

We shall now show that in fact the business had no gains for the year in question, for the net worth showed an enormous shrinkage, due entirely to the depression.

B.

The depreciation suffered by the Company in 1930 was greatly in excess of the net earnings reported in its income tax return.

The Company in its return reported income as follows:

Taxable net income (Sec. 13)	$863,787.22
Non-taxable income	90,858.40
Total net income under Section 104 (R. 13)	$954,645.62

Exhibit 15 (R. 146) shows that respondent suffered depreciation in securities for its fiscal year ended January 31, 1931, aggregating $943,517.42.

Mr. Ferguson (R. 93), Mr. Field (R. 87), and Mr. Armbruster (R. 96) testified that the local bank stocks should be eliminated from the statement because they were unsalable, had no liquidity, and could not be used as collateral for loans. In other words, the corporation could not raise money by selling them; and they had lost all their value for obtaining credit of borrowing money.

Therefore, the following securities must be eliminated from Exhibit 15 (R. 146), to see the true condition of respondent:

Commercial Trust Company of New Jersey	$ 768,240.00
*First National Bank of Jersey City	38,600.00
Hudson County National Bank	127,654.00
First National Bank of Hoboken	15,360.00
New Jersey Title Guarantee & Trust Company	60,288.00
Trust Company of New Jersey	58,480.00
Total	$1,068,622.00
Deducting from the market value of all securities 1/31/31	$2,125,434.50
The estimated value of the local bank stocks, as shown above	1,068,622.00
There remains a market value of all the securities in the portfolio of	$1,056,812.50
The book value of the Company's gross assets 1/31/30 was	$9,245,266.75
As of 1/31/31	9,108,437.14
**Decrease in year (Ex. 6, R. 136)	$ 136,829.61
Add depreciation in securities	943,517.42
Add book value of local bank stocks which had lost all value	1,068,622.00
***Shrinkage in values for year at least	$2,148,969.03

* It is true as the Solicitor General points out on page 24 of his brief that the company purchased 300 shares of this stock at $76.00 per share in 1930. But, Exhibit 23 (R. 162) indicates this purchase was made in August, when the price ranged from $90.00 to $75.00, but it had dropped to $50.00 by December.

** Miss Mullins estimated that the inventory had dropped in value between $200,000.00 and $250,000.00 (R. 81).

Mr. Gaddis estimated that the fair market value of the buildings, machinery and equipment had depreciated by $125,000.00 (R. 98).

*** We have not deducted anything for loss in book value of stocks in banks located outside Hudson County, where the Company's offices and warehouses are located, although the evidence of no value applies to them as well as the stocks of local banks.

Instead of a gain for the year the Company actually suffered a decrease in the value of its gross assets of over $2,000,000.00 (all the "profits" for the year on which it paid income taxes of $103,616.60, were included in the assets as of January 31, 1931, above mentioned, including the $103,616.60 income tax, which was not payable until April 15, 1931).

POINT V.

Respondent's gains and profits were not permitted to accumulate beyond the reasonable needs of the business.

There is not a word of testimony in this record from which an inference properly can be drawn that the capital and surplus were in excess of the reasonable needs of the business.

What are the reasonable needs of a business? It is obvious that a corporation owning one grocery store needs less capital than a corporation owning 815 stores. It would seem obvious at first glance that a corporation in the business of manufacturing automobiles, which produces one million cars a year, would require more capital than a competitor which manufactures a hundred thousand cars a year. Yet, the cost of building the hundred thousand might exceed the cost of producing the million which the first manufacturer produces. They may be hand-made, of finer quality and workmanship than the million cars. Or, two corporations just like respondent may be in the grocery business in different sections of the country. One corporation may own the real estate on which its 815 stores are located. The

other may rent its store locations. One may produce on its own farms its wheat, fruits and vegetables, manufacture its own flour, and can the fruits and vegetables. The other may buy in bulk and sell at retail. Do they both require the same capital? One of these supposititious corporations may cover with stores the entire area within trucking distance of its manufacturing plant. The other, like petitioner, may cover three-fourths of that area. They may both require the same capital; they may not.

The plans for the development of the one, economic conditions under its own peculiar situation, fears of flood or drought or anticipated labor troubles may require its management to conserve every possible cent of its gains and profits against the day of adversity. Only the management of the business can know of such matters and appreciate the perils they portend for the business.

When Section 104-B speaks of the reasonable needs of the business, what does it mean? The word "reasonable" shows an intention on the part of the Congress not to stagnate business but to permit business to grow and expand. Who can tell better than the management and its bankers what the reasonable capital needs of a business are? Theirs is the concern for the safety of the business; theirs the duty to finance it; theirs is the loss if the capital and surplus of the business are so depleted by dividends that bills cannot be paid at maturity and receivership ensues. If the business goes on and prospers and makes net earnings, then the greater the earnings the more the owners make and the more the Government receives in taxes. The mere fact that the surplus of a business is large does not, standing alone, prove that it is too large. This corporation has 100,000 customers per day (R. 83) visiting its stores, who

must be constantly supplied with food. The management is required always to have on hand available for distribution to these stores an adequate supply of merchandise. If war or famine should come, there is the necessity of careful management being in a position to buy instantly a supply of food for many months into the future (R. 72).

Mere size of a surplus cannot determine the "reasonable needs of the business", for while a surplus of $9,000,000 would be wholly disproportionate to one grocery store doing a business of $50,000 a year, it would be wholly inadequate for the Ford Motor Company doing a business of hundreds of millions of dollars per year. Yet, the Solicitor General contends that the Circuit Court of Appeals erred when it found from an examination of this record that there was no evidence, substantial or otherwise, to support its finding. How could the Court of Appeals have found otherwise when not a witness testified either that the surplus, though large, was too large, or that the purpose of the management was different from what the management testified under oath?

Reasonable needs of a business include many factors, such as, proper working capital, proper reserves for contingencies foreseeable and unforeseeable, droughts, floods, wars, labor disputes, lack of products, depressions and recessions, and reserves for proper growth and expansion of the business.

The Solicitor General, in his brief (p. 23) chides the Court below because it stated the respondent had a right to provide surplus to aid it in case of fires, earthquakes, floods, wars, strikes, boycotts and other contingencies, and states that no witness stated that earthquakes, floods, etc. were probable in New Jersey, but such contingencies were real and entirely probable.

Since 1930 a vast world-wide depression has occurred, bringing ruin to many long established and apparently financially sound institutions. Great floods came and great droughts occurred, covering large areas of farm lands, causing scarcity of food products; wars have come (not here in America, but on the other side of the world), of so great an extent as to cause great unrest and uncertainty among nations; great labor unrest has come about; strikes and boycotts have occurred, throwing many thousands of men out of work; demands of labor for shorter hours and higher wages have come about, requiring greater expenditures in wages and employment of more men; a great recession now exists.

All of the foregoing the wise business man foresees, or tries to foresee, and provides against.

Provision for such eventualities is provision for the reasonable needs of the business.

We submit that the words "reasonable needs of the business" were obviously used by Congress for the purpose of giving wide latitude to the management of business; they indicate no intention of preventing business from growing. They mean not the needs of the moment, but were purposely intended to give conservative executives the latitude which prudent business men need in the conduct of their affairs.

If the Board of Tax Appeals could properly and lawfully find from a mere inspection of the balance sheets and other documents in evidence in this case, that the surplus of National Grocery Company was beyond the reasonable needs of the business, it must follow that sworn testimony has lost its place in judicial proceedings and there need be no further provisions in the law for appeals from administrative Boards.

Every business must have capital. Even the newsboy in the street must have a few pennies with which to buy the papers he sells. The mere fact that a large business has large capital cannot in the essence of things, standing alone, prove that it is too large. The surplus of this business was invested in warehouses, an office building, stores, trucks, merchandise, and a part in cash and securities. The gross sales for the year under review were over $25,000,000 or nearly three times the gross assets of the business and from six to eight times the working capital.

Since there was no proof whatever before the Board either that the surplus of this business was in excess of its reasonable requirements or that the directors were actuated by the forbidden purpose, the Circuit Court of Appeals did not err in reversing the determination of the Board.

POINT VI.

Section 104 is not a tax on income; it is a direct tax on a purpose, or state of mind; hence void.

"Purpose" is defined to be:

> "That which one set before himself as an object to be attained; the end or aim to be kept in view in any plan, measure, exertion, or object; design; intention; the object, effect, or result aimed at, intended, or attained; as energy applied to little purpose."
>
> *Webster's New International Dictionary.*

The most careful analysis leads to the inevitable conclusion that this section is nothing less than an attempt to levy a tax or penalty upon a state of mind. It is not a

duty, impost or excise. It is not a tax on income. Although the tax is measured by income, it is not the receipt of income which is taxed. The receipt of income is not the event or circumstance which provokes or authorizes the imposition of the tax, nor is the mere retention of income in the form of surplus the circumstance or event which is taxable. The mere retention of income is not an act or an event and hence cannot be the subject of an excise tax. Indeed, it must be self-evident that a tax upon the mere retention and accumulation of income in the form of a corporate surplus would not be an *income* tax within the meaning of the 16th amendment. The tax is, therefore, imposed upon a mere purpose or intention. It is an attempted direct penalty upon the assets of a corporation because the majority of the board of directors have a design to avoid paying surtaxes on income of the shareholders that would be levied if they took certain action which they refrain from taking—namely declaring and paying dividends.

The tax sought to be imposed by Section 104 rests solely upon a classification premised upon a state of mind and without relation to tax avoidance *ipso facto*, and without respect as to whether the purpose condemned ever becomes a matter of accomplishment. As was said in *United Business Corporation* vs. *Commissioner*, 19 B. T. A. 809.

> "The emphasis of the statute is placed upon the purpose and if this purpose clearly appears the corporation is subject to the tax whether the accumulations be large or small."

And again said the Board of Tax Appeals in *Cecil B. DeMille* vs. *Commissioner*, 31 B. T. A. 1161;

> "But the taxes under these statutory provisions are not imposed because of effects; avoidance *per se* is not prohibited. It is the *purpose*, the intention

> motivating a course of conduct which is made controlling by the very words of the statute."

The Courts have said that this is:

> "A statute which stands on the footing of the participants' state of mind * * * the test remains the state of mind itself, * * *" *United Business Corporation* vs. *Commissioner,* 62 Fed. (2d) 754.

A statute undertaking a classification based upon nothing more than a mere intention, and without respect or regard to ultimate execution of that intention does violence to the fundamental principles of jurisprudence that a mere state of mind, however vicious it may be, but without more, is a matter beyond the ambit of temporal jurisdiction.

4 Blackstone Comm., p. 21.

And where the Government is defrauded of its revenues or where an attempt to so defraud is made, the law punishes the act or the attempt, but not the *intention* to defraud.

U. S. vs. *Riddle,* 5 Cranch. 311.

See also, *Chisholm* vs. *Commissioner,* 79 Fed. (2d), 14, where it is said,

> "It is important to observe just what the Supreme Court held in that case (Gregory *vs.* Helvering, 293 U. S. 465). It was solicitous to reaffirm the doctrine that *a man's motive to avoid taxation will not establish his liability if the transaction does not do so without it.* It is true that that Court has at times shown itself indisposed to assist such efforts. * * *, *but it has never, so far as we can find, made that purpose the basis of liability; and it has often said that it could not be such.*"
>
> (Parenthesis and italics supplied.)

Nor is the classification undertaken to be made by Section 104 based upon any principle elsewhere condemned by law.

> "The legal right of a taxpayer to decrease the amount of what would otherwise be his taxes, or altogether avoid them by legal means which the law permits cannot be doubted."
>
> *Gregory* vs. *Helvering*, 293 U. S. 465.

> "A purpose to minimize or avoid taxation is not an illicit motive."
>
> *Sawtell* vs. *Commissioner*, 82 Fed. (2d) 221.

> "There was nothing unlawful or even mildly unethical in the motive of petitioner to avoid some portion of the burden of taxation."
>
> *Marshall* vs. *Commissioner*, 57 Fed. (2d) 633.

> "Anyone may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes."
>
> *Helvering* vs. *Gregory*, 69 Fed. 2d. 809.

> "The purpose to save income taxes is now legally above reproach."
>
> *Rands Inc.* vs. *Commissioner*, 34 B. T. A. 1094, 1106.

See also, *Sawtell* vs. *Commissioner*, 82 Fed. 2d. 221, *Commissioner* vs. *Eldridge*, 79 Fed. 2d. 629 and *Jones* vs. *Helvering*, 71 Fed. 2d. 214, 217.

In *Superior Oil Co.* vs. *Mississippi*, 280 U. S. 390, 395, Mr. Justice Holmes stated:

> "The fact that it (the appellant) desired to evade the law, as it is called, is immaterial, because the very meaning of a line in the law is that you intentionally may go as close to it as you can, if you do not pass it."

To the same effect, Mr. Justice Holmes said in *Bullen* vs. *Wisconsin*, 240 U. S. 625, 630:

> "* * * We do not speak of evasion, because, when the law draws a line, a case is on one side of it or the other, and if on the safe side is none the worse legally that a party has availed himself to the full of what the law permits. When an act is condemned as an evasion, what is meant is that it is on the wrong side of the line indicated by the policy if not by the mere letter of the law."

If a corporation permits its gains and profits to accumulate *without* a purpose to prevent the imposition of a surtax upon its stockholders, the corporation is on the safe side of the line drawn by the law notwithstanding the fact that the surtax is thereby avoided. If, on the other hand, a corporation permits its gains and profits to accumulate *with* a purpose to prevent the imposition of the surtax upon its stockholders, section 104 attempts to put the corporation on the wrong side of the line drawn by the law. It is submitted that in substance, purpose and effect section 104 is tax on a *purpose* to stay on the safe side of the line which the law has drawn.

If tax avoidance, *ipso facto*, cannot be the basis for liability, irresistible logic constrains a rule that a classification for tax based on nothing more than a purpose to effect avoidance is so clearly without reasonable ground for support and so patently unnatural that the tax sought to be

imposed is void as a direct tax not levied in proportion to the population, and also in conflict with the due process clause of the Fifth Amendment.

POINT VII.

Section 104 is not a tax on income within the meaning of the Sixteenth Amendment, but is a penalty designed to force corporations lawfully formed under State laws to distribute their earnings in order to create a basis for taxation against the stockholders, hence is void.

Vice President Garner when a member of the Ways and Means Committee of the House of Representatives, in explaining Section 104 to the House, said:

> "Section 104 is entirely new. It is inserted in the bill in response to the Advisory Committee's criticism of the administration of Section 220 in the present law. I am sure you will remember what Section 220 in the present law is. It was intended to enable the Secretary of the Treasury to force corporations to distribute their profits and subject their shareholders to the tax levied by Congress. It has been in the statute for some years" (Appendix, p. 101).

In the debate in the House on the section Mr. Green of Iowa said:

> "You will not find much direct revenue raised by this provision but the effect will be to dissolve a number of these corporations that were formed to escape the surtax, and the persons who own them will pay their surtax in the regular way, the same as other people. That will be the effect. * * *

> I am told by gentlemen familiar with the operations of these corporations and gentlemen connected with large accounting firms and others that Section 220 of the present law, while it never brought in any revenue, operated in such a way as to cause a great many of these corporations to dissolve. It has been, in fact, a most excellent scarecrow, if it has been nothing else, and it has driven these people into taking such action as to avoid the penalties prescribed" (Congressional Record—House, p. 520, December 12, 1927). (Appendix, p. 101.)

The constitutionality of section 220 as applied to an operating company was seriously questioned by Mr. Gregg and by Senator Jones on the hearings before a Select Committee on investigation of the Bureau of Internal Revenue, Sixty-Eighth Congress (Appendix, pp. 94, 95).

It seems to have been conceded that the section had no force or effect against a corporation in a mercantile or industrial business (Secretary Mellon, Appendix, p. 84; Representative Jones, Appendix, p. 85; Mr. Manson, Appendix, p. 91).

The Sixteenth Amendment is as follows:

> "The Congress shall have power to lay and collect taxes on income, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration."

The Amendment was declared effective in a Proclamation dated February 25, 1913.

In determining whether the penalty attempted to be imposed by Section 104 of the Revenue Act of 1928, is a tax on income within the meaning of the Sixteenth Amendment, an examination of the revenue laws is important.

Section 13 of the Revenue Act of 1928, provides:

> "There shall be levied, collected, and paid for each taxable year upon the net income of every corporation, a tax of 12 per centum of the amount of the net income in excess of the credits against net income provided in Section 26."

Section 26 states:

> "For the purpose only of the tax imposed by section 13 there shall be allowed the following credits:
>
> (a) The amount received as interest upon obligations of the United States which is included in gross income under section 22; and
>
> (b) In the case of a domestic corporation the net income of which is $25,000 or less, a specific credit of $3,000; but if the net income is more than $25,000 the tax imposed by section 13 shall not exceed the tax which would be payable if the $3,000 credit were allowed, plus the amount of the net income in excess of $25,000."

Unquestionably Section 13 properly levied an income tax upon the net income of every corporation in the United States.

The provisions of the Income Tax Law imposing taxes upon individuals are Sections 11 and 12.

Section 11 provides for a normal tax on individuals equal to the sum of the following:

> "(a) 1½ per centum of the first $4,000 of the amount of the net income in excess of the credits against net income provided in section 25;
>
> (b) 3 per centum of the next $4,000 of such excess amount; and

(c) 5 per centum of the remainder of such excess amount."

Section 12 provides that there shall be levied, collected, and paid for each taxable year upon the net income of every individual a surtax as specified in the section.

It is clear that the purpose of Section 104 was twofold: (first) to force the distribution of corporate earnings to stockholders in order to increase the income of stockholders, to the end that more surtaxes might be levied than otherwise; and, (second) heavily to penalize corporations that did not distribute their earnings in the form of dividends.

That this section as it operates upon respondent is a penalty cannot be doubted.

The leading case construing such a penalty is *Helwig* vs. *United States,* 188 U. S., 605. The Tariff Act of 1890 imposed an *ad valorem* duty of ten per centum on the importation of wood pulp. Section 7 provided that if the importer should not declare the value correctly, and that if the appraised value exceeded by more than ten per centum the value declared in the entry, there should be levied, collected and paid, in addition to the duties imposed by law, a further sum equal to two per centum of the total appraised value for each one per centum that such appraised value exceeded the value declared, and that if such appraised value shall exceed the value declared in the entry more than forty per centum, such entry may be held to be presumptively fraudulent. The declared value of this importation was $13,252, and the duty of $1,325 was paid. The merchandise was later appraised at $16,792, and a penalty was assessed against the importer of $9,067, and suit brought therefor against the importer in the United

States Circuit Court in New York. The case was tried on an agreed state of facts, and motion was made to dismiss and for judgment for defendant on the ground the action was to recover a penalty or penalties arising under the customs laws and that the Circuit Court had no jurisdiction.

Mr. Justice Peckham, speaking for this Court, said (p. 613):

> "Although the sum imposed by reason of undervaluation may be simply described as 'a further sum' or 'an additional duty,' if it is yet so enormously in excess of the greatest amount of regular duty ever imposed upon an article of the same nature, and it is imposed by reason of the action of the importer, such facts clearly show it is a penalty in its intrinsic nature, and the failure of the statute to designate it as a penalty, but describing it as 'a further sum,' or 'an additional duty,' will not work a statutory alteration of the nature of the imposition, and it will be regarded as a penalty when by its very nature it is a penalty. It is impossible, judging simply from its language, to hold this provision to be other than penal in its nature." • • •
>
> The judgment was reversed.

Convincing proof that Section 104 imposes a penalty is afforded by Section 293(b) of the Revenue Act of 1928, which reads:

> "If any part of any deficiency is due to fraud with intent to evade tax, then 50 per centum of the total amount of the deficiency (in addition to such deficiency) shall be so assessed, collected, and paid, in lieu of the 50 per centum addition to the tax provided in Section 3176 of the Revised Statutes, as amended."

See also Sec. 293(a) which provides a penalty of 5% for negligence.

In other words, the penalty imposed upon a fraud-doer under the Act of 1928 is 50 per centum *of the tax,* whereas the penalty under Section 104 of the same Act is 50 per centum *of the income,* including dividends and income from tax exempt securities,—a much more severe penalty than for a fraud.

In the *Child Labor Tax* case, 259 U. S. 34, Chief Justice Taft said:

> "Grant the validity of this law, and all that Congress would need to do hereafter, in seeking to take over to its control any one of the great number of subjects of public interest, jurisdiction of which the states have never parted with, and which are reserved to them by the 10th Amendment, would be to enact a detailed measure of complete regulation of the subject and enforce it by a so-called tax upon departures from it. To give such magic to the word 'tax' would be to break down all constitutional limitation of the powers of Congress and completely wipe out the sovereignty of the states.
>
> The difference between a tax and a penalty is sometimes difficult to define, and yet the consequences of the distinction in the required method of their collection often are important. Where the sovereign enacting the law has power to impose both tax and penalty, the difference between revenue production and mere regulation may be immaterial; but not so when one sovereign can impose a tax only, and the power of regulation rests in another. Taxes are occasionally imposed in the discretion of the legislature on proper subjects with the primary motive of obtaining revenue from them, and with the incidental motive of discouraging them by making their continuance onerous. They do not lose their character as taxes because of the incidental

motive. *But there comes a time in the extension of the penalizing features of the so-called tax when it loses its character as such* and becomes a mere penalty, with the *characteristics of regulation and punishment.* Such is the case in the law before us. Although Congress does not invalidate the contract of employment, or expressly declare that the employment within the mentioned ages is illegal, it does exhibit its intent practically to achieve the latter result by adopting the criteria of wrongdoing, and imposing its principal consequence on those who transgress its standard."

Hill vs. *Wallace,* 259 U. S., 44;
Hammer vs. *Dagenhart,* 247 U. S., 251.

Chief Justice Marshall in *M'Culloch* vs. *Maryland,* 4 Wheat., 316, said:

> "Should Congress, in the execution of its powers, adopt measures which are prohibited by the Constitution, or should Congress, under the pretext of executing its powers, pass laws for the accomplishment of objects not intrusted to the government, it would become the painful duty of this tribunal, should a case requiring such a decision come before it, to say that such an act was not the law of the land."

The declared object of the Narcotic Law is to provide revenue, and the Supreme Court has held that "whatever additional moral end it may have in view must be reached only through a revenue measure and within the limits of a revenue measure."

United States vs. *Jin Fuey Moy,* 241 U. S., 394.

The Court said in *Linder* v. *U. S.,* 268 U. S. 5:

> "Congress cannot, under the pretext of executing delegated power, pass laws for the accomplishment of objects not intrusted to the Federal government. And we accept as established doctrine that any provision of an act of Congress ostensibly enacted under power granted by the Constitution, not naturally and reasonably adapted to the effective exercise of such power, but solely to the achievement of something plainly within power reserved to the states, is invalid, and cannot be enforced."

In *United States* vs. *Butler,* 297 U. S., 1, Mr. Justice Roberts said at page 74:

> "Congress has no power to enforce its commands on the farmer to the ends sought by the Agricultural Adjustment Act. It must follow that it may not indirectly accomplish those ends by taxing and spending to purchase compliance. The Constitution and the entire plan of our government negative any such use of the power to tax and to spend as the act undertakes to authorize. • • • If, in lieu of compulsory regulation of subjects within the states' reserved jurisdiction, which is prohibited, the Congress could invoke the taxing and spending power as a means to accomplish the same end, clause 1 of section 8 of Article I would become the instrument for total subversion of the governmental powers reserved to the individual states."

In the bituminous coal case, *Carter* vs. *Carter Coal Co.,* 298 U. S., 238, Mr. Justice Sutherland said, that the so-called excise tax of 15 per centum on the sale price of coal at the mine, or, in the case of captive coal and return the fair market value, with its drawback allowance of 13½%, is clearly not a tax but a penalty. He added:

> "It is very clear that the 'excise tax' is not imposed for revenue but exacted as a penalty to compel compliance with the regulatory provisions of the act. The whole purpose of the exaction is to coerce what is called an agreement—which, of course, it is not, for it lacks the essential element of consent. One who does a thing in order to avoid a monetary penalty does not agree; he yields to compulsion precisely the same as though he did so to avoid a term in jail.
>
> The exaction here is a penalty and not a tax within the test laid down by this court in numerous cases" (citing them).

If it should be contended that Section 104 was not designed to operate as a compulsion against corporations, but merely gave them a choice, and that they could avoid the penalty by declaring dividends, a complete answer is given by this Court in *Frost & F. Trucking Co.* vs. *Railroad Commission*, 270 U. S., 583, 593, where it is said:

> "In reality, the carrier is given no choice, except a choice between the rock and the whirlpool,—an option to forego a privilege which may be vital to his livelihood, or to submit to a requirement which may constitute an intolerable burden."

Section 104 cannot be sustained as a necessary aid to the effective *enforcement* of the law imposing surtaxes on individuals, for the reason that, as applied to a *bona fide* operating company, the obvious purpose and effect of the section is not to prevent *evasion* of personal surtaxes, but is, on the contrary, to control and regulate the dividend policy of domestic corporations so that income not otherwise existing or taxable under the revenue laws and under

the constitution, may be created and be subjected to taxation.

Where a man who has been in receipt of a taxable income of a million dollars a year from stocks and bonds, transfers those securities to a corporation after a personal surtax law has been enacted, it may well be said that his action constitutes evasion of the tax law. Such conduct is in the nature of a fraudulent conveyance; and it may well be argued that Congress has power to tax that individual or his corporation in the same manner as if such transfer had never been made.

Indeed, in the early income tax laws Congress proceeded on this theory and imposed a tax, without penalty, on the individual shareholder rather than on the corporation to which such a transfer had been made. (Tariff Act of 1913, Appendix, p. 78; Revenue Act of 1916, Appendix, p. 79; Revenue Act of 1919, Appendix, p. 80.) In the Revenue Act of 1921, however, and as a result of the decision of this Court in *Eisner* vs. *McComber*, 252 U. S. 189, this provision was changed and Congress provided for a penalty on the corporation instead of a tax on the individual shareholder (Revenue Act of 1921, Appendix, p. 81; Report of the Committee on Ways and Means, 1921, Appendix, p. 82).

As applied to an operating company formed before the Sixteenth Amendment was adopted Section 220 of the Revenue Act of 1921 and all of its successor sections, including Section 104 of the Revenue Act of 1928, clearly had no other purpose than by the use of an arbitrary penalty, to *create* a basis for taxation where none otherwise existed. Statement by Garner (M. C.) (Appendix, p. 101).

Congress might, with greater justification, have provided that any citizen who permits his money to remain invested in tax exempt bonds and obligations of the several states and subdivisions thereof, for the purpose of preventing the imposition of the surtax, shall be subject to a tax equal to 50 per cent of his net income as reported, which shall be in addition to the tax otherwise imposed. There is no difference in principle between Section 104 as applied to respondent and the use of a penalty to prevent a citizen from investing in or keeping his funds invested in tax exempt securities.

POINT VIII.

Section 104 improperly invades the domain reserved to the States by the Tenth Amendment.

As to corporations *formed* by rich men for the purpose of avoiding the imposition of the surtax, Section 104 of the Revenue Act of 1928 and Section 220 of the earlier Revenue Acts has been held valid and enforceable.

United Business Corporation vs. *Commissioner*, 62 Fed. (2d) 754; certiorari denied 290 U. S. 635;

Williams Inv. Co. vs. *United States*, 3 F. Supp. 225;

Saenger, A. D., Inc. vs. *Commissioner*, 84 Fed. (2d) 23; certiorari denied, 299 U. S. 577;

Almours Securities vs. *Commissioner*, 91 F. (2d) 427; certiorari denied January 10, 1938.

As to such corporations expressly formed for the sole purpose of tax avoidance, Congress has the power to im-

pose the income tax, and may have the power to penalize the transaction as a fraud against the revenues.

But as to corporations like respondent, formed long before the income tax laws were passed, and which were engaged in *bona fide* business operations, Congress has power to impose an income tax, but has no power to regulate their internal affairs.

The act may be valid as to the one and invalid as to the other.

Nashville, C. & St. L. R. Co. vs. *Walters,* 294 U. S. 405;

Champlin Ref. Co. vs. *Corporation Commission,* 286 U. S. 210.

Congress, for instance, has no power to provide what the corporate powers of a corporation may be; or under what conditions a corporation formed under the laws of a State may operate; or how large a capital it shall have and into what number of shares and of what par value it may be divided; it cannot regulate how much of the capital of such a corporation must be paid in, nor what the duration of the charter may be. Such matters are reserved to the States by the Tenth Amendment.

All of the States have laws providing for the incorporation of corporations. The States tax such corporations for their own benefit. If Congress may compel the distribution of the earnings of a *bona fide* business corporation by this law, then by like penalties it may regulate all of the internal affairs of corporations.

By like method it can regulate the affairs of every citizen and taxpayer in the nation.

If Congress may impose this penalty, then it may impose a like penalty on a corporation that has a capital in

excess of a given amount; or has a surplus beyond a certain amount. If this law is valid Congress may limit the number of employees a corporation may have; it may limit the kind and amount of business transacted; the area in which it may transact business; the wages paid; the salaries of officers and directors; the size and location of offices, warehouses, factories and every detail of the business.

If this law is valid what is there to prevent Congress putting a like penalty on any citizen who makes a contribution for the erection of a synagogue or a church, or who contributes to foreign or home missions, or who contributes moneys for the support of any political party?

As Chief Justice Taft said in the *Child Labor Tax* case, 259 U. S. 34,

> "there comes a time in the extension of the penalizing features of the so-called tax when it loses its character as such and becomes a mere penalty, with the characteristics of regulation and punishment."

As to corporations formed for the express purpose of tax avoidance, Congress has the power to impose an income tax and may have the power to penalize the transaction as a fraud against the revenues, but as to corporations formed for *bona fide* business purposes, Congress has the power to tax, but the States have the power to regulate. Our form of government requires that each shall be confined to its own domain.

The National Grocery Company under the regulations of the State of New Jersey grew from a corporation of insignificant size, operating three stores, to a large and successful corporation in 1930, operating 815 stores, with sales of merchandise amounting to over $25,000,000.00. It owned

and operated in connection with its merchandising business, administrative offices, warehouses, manufacturing plants and apparatus, stables and garages, a large bakery, extensive delivery equipment, store fixtures and furniture, and a miscellaneous stock of merchandise contained in its retail stores and distributing warehouses, on which it paid local taxes.

In twenty-two years its employees grew from a handful to 2,332. It paid local and State taxes for the year under review of $36,371.87 (Ex. 4, R. 133). By consistently pursuing the policy that the management had adopted at the inception of the business of ploughing the earnings back into the business, the Company year by year grew larger and stronger. Each year as its property increased, its taxes increased; as its business increased, the number of its employees and the amount of its purchases of goods and merchandise increased. It is obvious that as this business grew and prospered, it became far more important to the public than to its individual owner, for while the benefit to him in the form of net earnings was large, nevertheless the benefit to the public was far greater, in the purchase of materials of all kinds, the payment of rents and taxes, and the wages of 2,332 employees.

This corporation was organized under the provisions of the New Jersey Corporation Act. That Act, as amended (P. L. 1926, page 541, Section 47), permits corporations to regulate the whole matter of the distribution of profits by dividends to stockholders.

> "47. Unless otherwise provided in the original or amended certificate of incorporation, or in a by-law adopted by a vote of at least a majority of the stockholders, the directors of every corporation or-

ganized under this act shall have power in their discretion from time to time to fix and to vary the amount of the working capital of the corporation and to determine, what, if any, dividends shall be declared and paid to stockholders out of its surplus or net profits. Dividends may be declared and paid in capital stock with or without par value.

"If so provided in its certificate of incorporation or in an amendment thereof, every corporation organized under this act shall have the power to create a sinking fund of a specified amount or proportion of its net profits for the purchase, retirement or redemption of any class or classes of preferred stock and to apply such sinking fund to such purpose."

P. L. 1926, Chap. 318, p. 541.

Until a dividend is declared the entire assets of the corporation, including surplus or accumulated profits in whatever form they exist, belong to the corporation, and the corporation owes no debt in respect thereto to the stockholders as individuals.

See

Stevens vs. *United States Steel Corporation,* 68 N. J. Eq., 373.

The rule in every jurisdiction is that the determination of the dividend fund, which always calls for a determination of the part or amount of profits to be retained or surplus to be accumulated, rests in the practically unfettered discretion of the board of directors, and the exercise of that discretion will never be set aside by the courts unless and until it is clearly and convincingly shown to have been exercised for a purpose foreign to the accomplishment of the

objects of the corporation; that is to say, to benefit a particular shareholder or group to the disadvantage of others, or to prejudice or "freeze out" a particular shareholder, or to embark upon a venture not within the corporate powers.

Neither the courts nor the Commissioner can displace the board of directors and substitute their judgment for that of the board in the absence of clear proof of unlawful exercise of power.

United States vs. *Philadelphia Knitting Mills*, 273 Fed. 657.

The exercise of directors' discretion turns on business expediency and not on strict necessity or rules of law—not on the whims or predilections of the Commissioner.

The Courts have repeatedly held that the discretion of directors in declaring dividends cannot be controlled or revised by courts unless it is made to appear clearly and convincingly that their acts were fraudulent or collusive or destructive of the rights of shareholders.

New York, Lake Erie & Western Railroad v. *Nickals*, 119 U. S. 296 (1886);

Gibbons v. *Mahon*, 136 U. S. 549 (1890);

State of Missouri, ex rel. Southwestern Bell Telephone Co. v. *Public Service Commission*, 262 U. S. 276 (1923);

Federal: Wilson v. *American Ice Co.*, 206 Fed. 736 (D. C., N. J., 1913);

New Jersey: Park v. *Grant Locomotive Works*, 40 N. J. Eq. 114 (1885), affirmed 45 N. J. Eq. 244;

Raynolds vs. *Diamond Mills Paper Co.*, 69 N. J. Eq. 299 (1905);

Blanchard vs. *Prudential Insurance Co.*, 80 N. J. Eq. 209 (1912);
Murray v. *Beattie Mfg. Co.*, 79 N. J. Eq. 604 (1912);
Levitan v. *North Jersey Holding Co.*, 106 N. J. Eq. 517 (1930);
Auburn Button Works vs. *Perryman Electric Co., Inc.*, 107 N. J. Eq. 554 (1931);
Madsen v. *Burns*, 108 N. J. Eq. 275 (1931);
Shonnard v. *Elevator Supplies Co., Inc.*, 111 N. J. Eq. 94 (1932);
Ace Bus Transportation Co. v. *So. Hudson County Boulevard Bus Owners' Association*, 118 N. J. Eq. 31 (1935);

Congress never intended that Section 104 should be extended as the Commissioner has attempted to extend it in this instance.

As Mr. Manson said in testifying before the Select Committee in 1925, this section, as applied to manufacturing companies and things of that sort, has no force or effect whatever (Appendix, p. 96).

Secretary Mellon testified before the Committee on Finance of the Senate April 3, 1924, that as to corporations that are organized to carry on business, that are developing the business, "there is a growth to the business, and that Section 220 does not apply to them" (Appendix, p. 85).

Clearly, as applied to corporations in active business, formed, existing and regulated by the laws of the States and not formed for the purpose of tax avoidance, Section 104 is unconstitutional as in conflict with the 10th Amendment.

POINT IX.

Section 104 of the Revenue Act of 1928 as applied to respondent deprives it of its property without due process of law, and is void as in conflict with the Fifth Amendment.

Section 104 is unreasonable, arbitrary and capricious in the following respects:

(1) Directors cannot tell from a study of Section 104 how to avoid the penalty for these reasons:

(a) There is no standard or gauge whereby they can tell what relation there may properly be between capital and surplus on the one hand and volume of business done on the other;

(b) no standard is set up by the Act showing what reserves may properly be set up by the directors for expansion of the business, for obsolescence of plant and machinery, for unusual depreciation caused by depressions and recessions, and for losses due to strikes, walkouts, fire, flood, holdups, thefts, embezzlements, drought, famine, and other perils that business must anticipate;

(c) the statute sets up no standard as to the amount of dividends that must be paid by a corporation to avoid the penalty, either as to amount of dividends, or as to the proportion of reported net earnings that must be declared and paid as dividends.

(2) No standard or formula is specified in the statute according to which the Commissioner of Internal Revenue must apply the penalty; each Commissioner will necessarily follow his own prejudices and predilictions.

(3) No standard or formula is specified in the statute whereby the directors of a corporation may know when and under what circumstances the penalty will be enforced by the Commissioner.

(4) The minority of the stockholders and directors may try unsuccessfully to force the payment of dividends. The majority may refuse to pay dividends. Yet this penalty falls alike on the property of both, although the minority not only have no intention of avoiding the surtax, but even tried unsuccessfully to have dividends declared that would subject them to the imposition of the surtax.

(5) The penalty may be imposed at the discretion, or mere whim of the Commissioner of Internal Revenue.

(6) Directors necessarily make their decision as to the advisibility of paying dividends in the light of present conditions. The determination of the Commissioner to assess the penalty cannot be made until after the tax return is filed, and may not be made until several years after the end of the taxable year (in this case it was three years afterward (R. 11)). The Commissioner has the benefit of hindsight, and necessarily acts from a substantially different base than the directors. The penalty is assessed retroactively and bears interest from the date the income tax for the year was payable, hence is in fact a greater penalty than is specified in the statute.

(7) The penalty bears no relation whatever in amount to surtaxes avoided.

(8) The penalty being enforceable within the arbitrary and uncontrolled discretion of the Commissioner of Internal Revenue in an amount five times the amount of the income tax, and several

> times the amount of the penalty prescribed by statute for fraud on the revenues, is an instrument of oppression and imposition without parallel in the revenue laws.

As to corporations in active mercantile and manufacturing businesses, using all their ingenuity and abilities to grow and expand, trying to give as much employment as possible, to manufacture, buy and sell as much goods as possible, and ready and willing to pay all proper taxes on the income of their labor and the fruits of their capital, this penalty is nothing less than a confiscation of property.

If there are two or more corporations of equal size, doing the same business and the same volume of business, the Commissioner may levy the penalty on one and not on the other. The directors of neither corporation can tell when the penalty will be levied until the ninety day notice is received. Or, the Commissioner may assess the penalty against neither.

In this case the income tax return was filed April 15, 1931. The sixty day notice of the imposition of the penalty was mailed April 25, 1934 (R. 11). Therefore before the penalty was assessed interest of $85,924.92 had accumulated (6% × 3 years × $477,360.68). When levied the penalty was not 50 per cent of the net profits as the statute provides, but 50 per cent plus 18 per cent.

This Court has recognized that a statute purporting to tax may be so arbitrary and capricious as to amount to confiscation and offend the Fifth Amendment.

> *Brushaber* vs. *Union Pacific R. Co.*, 240 U. S. 1;
> *Barclay & Co.* vs. *Edwards*, 267 U. S. 442;
> *Nichols* vs. *Coolidge*, 274 U. S. 531.

Mr. Justice Sutherland in *Connally* vs. *General Construction Co.*, 269 U. S. 385, 391, said:

> "That the terms of a penal statute creating a new offense must be sufficiently explicit to inform those who are subject to it what conduct on their part will render them liable to its penalties, is a well recognized requirement, consonant alike with ordinary notions of fair play and the settled rules of law. And as a statute which either forbids or requires the doing of an act in terms so vague that men of common intelligence must necessarily guess at its meaning and differ as to its application violates the first essential of due process of law. International Harvester Co. *v.* Kentucky, 234 U. S. 216, 221; Collins *v.* Kentucky, 234 U. S. 634, 638."

Yu Cong Eng vs. *Trindad*, 271 U. S. 500;
Nebbia vs. *New York*, 291 U. S. 502;
United States vs. *Cohen Grocery Co.*, 255 U. S. 81.

POINT X.

Section 104 of the Revenue Act of 1928 is null and void because it reposes legislative power in the Commissioner of Internal Revenue, contrary to the letter and spirit of Article I, Section 1, and Article I, Section 8, par. 18 of the Constitution.

Article I, Section 1 of the Constitution provides:

> "All legislative powers herein granted shall be vested in a Congress of the United States, which shall consist of a Senate and House of Representatives."

Article I, Section 8, Par. 18 provides that:

> "The Congress shall have power to make all laws which may be necessary and proper for carrying into execution the foregoing powers, and all other powers vested by this Constitution in the Government of the United States, or in any Department or officer thereof."

Section 104 (a) operates when a corporation is "availed of for the purpose of preventing the imposition of the surtax upon its stockholders through the medium of permitting its gains and profits to accumulate instead of being divided or distributed", and (b) provides that the fact that the gains or profits are permitted to accumulate beyond the reasonable needs of the business, shall be *prima facie* evidence of a purpose to escape the surtax.

Paragraph (a) is not applicable in the absence of a purpose to prevent the imposition of the surtax. But the law does not specify how the purpose is to be ascertained. The penalty necessarily operates upon the mental processes of the directors of a corporation. No standard is set up for the determination of the purpose beyond section (b), which reposes in the Commissioner of Internal Revenue the duty to determine whether gains or profits are permitted to accumulate beyond the reasonable needs of the business. Congress has not set up any standard by which the Commissioner shall determine what are the reasonable needs of a business.

When Congress provided a tax on the net income of corporations under Section 13 of the Revenue Act, it adopted a standard and provided for a tax of twelve per cent upon the amount of net income in excess of certain defined credits against net income.

When Congress, however, enacted Section 104 of the Revenue Act it imposed the penalty not by any standard that was known to the general public, including the officers and directors of corporations, but it left the standard of what capital was required for the reasonable needs of the business solely to the discretion of the Commissioner of Internal Revenue. One Commissioner necessarily would have one standard and another a different standard. See Senator Smoot's statement (Appendix, p. 102).

Since Section 104 first appeared in the Tax Act of 1913, and no similar case has heretofore reached the Board of Tax Appeals or any Court, it is apparent that none of the Commissioners heretofore have attempted to collect the tax from *bona fide* business corporations needing capital for their very existence.

We submit this case is controlled by the following decisions of this court:

Panama Refining Co. vs. *Ryan,* the "hot oil" case, 293 U. S., 388;

the NRA case, *Schechter* vs. *United States,* 295 U. S., 495; and

the bituminous coal case, *Carter* vs. *Carter Coal Co.,* 298 U. S., 238.

In *Panama Refining Co.* vs. *Ryan* (*supra*), Chief Justice Hughes said:

> "The Congress left the matter" (transportation of "hot oil" exceeding state allowances) "to the President without standard or rule, to be dealt with as he pleased. The effort by ingenious and diligent construction to supply a criterion still permits such a breadth of authorized action as essentially to com-

> mit to the President the functions of a legislature rather than those of an executive or administrative officer executing a declared legislative policy."

In *Carter* vs. *Carter Coal Co.* (*supra*), Justice Sutherland said of the power to fix maximum hours of labor under the Bituminous Coal Conservation Act:

> "And a statute which attempts to confer such power undertakes an intolerable and unconstitutional interference with personal liberty and private property. The delegation is so clearly arbitrary, and so clearly a denial of rights safeguarded by the due process clause of the Fifth Amendment, that it is unnecessary to do more than refer to decisions of this court which foreclose the question" (citing cases).

In the case at bar neither the Commissioner of Internal Revenue, nor the Board of Tax Appeals has made any finding as to what the reasonable capital needs of the National Grocery Company are. No one will contend that it needs no capital. Without adequate capital it could not have discounted its bills payable—and such discounts in the year under review amounted to $493,719 (Exhibit 10, p. 141) or 57 per cent of the net earnings for the year. Assuming that the Company requires sufficient capital properly to carry on business, there has been no determination by anyone what that amount of capital is. Nor does the statute require such a finding. No standard or gauge is contained in the Act, according to which such a determination must be made by anyone. The whole matter is left to the unbridled control of the Commissioner, who, occupying the seat of Jove, may hurl the thunderbolt of a 50 per cent penalty whereso-

ever he will. The Constitution is the protector of business against such arbitrary and confiscatory acts.

It is the duty of Congress to lay down policies and establish standards, and leave to selected instrumentalities the making of subordinate rules within prescribed limits and the determination of facts to which the policy as declared by the legislature is to apply.

Schechter vs. *United States,* 295 U. S. at p. 530.

It follows that Section 104 is therefore void as to petitioner and all other *bona fide* business corporations requiring capital as their life blood.

POINT XI.

The Circuit Court of Appeals in reversing the determination of the Board followed the law, and should be affirmed.

The Circuit Court of Appeals from a study of the whole record having found that the Government offered no proof of the forbidden purpose against respondent, and that respondent affirmatively had proved it did not have the forbidden purpose, and that the earnings were accumulated for proper corporate purposes, followed the law in reversing the determination of the Board.

In 1921 the Circuit Court of Appeals below (Buffington, J.), finding that the Federal Trade Commission had disregarded a line of proof which was dispositive of the case, set aside an order of that Commission requiring the petitioner to desist from certain practices found by the Commission to be unfair competition.

Curtis Pub. Co. vs. *Federal Trade Commission,*
270 Fed. 881, 910.

On appeal this Court said:

"If there be substantial evidence relating to such facts from which different conclusions reasonably may be drawn, the matter may be and ordinarily we think should be remanded to the Commission—the primary fact finding body, with direction to make the additional findings; but if from all the circumstances, it clearly appears that in the interest of justice, the controversy should be decided without further delay, the court has full power under the statute so to do."

Federal Trade Commission vs. *Curtis Pub. Co.,*
260 U. S. 568.

"The Board of Tax Appeals is not a Court. It is an executive or administrative board, upon the decision of which the parties are given an opportunity to base a petition for review to the courts after the administrative inquiry to the board has been had and decided."

Old Colony Trust Company vs. *Commissioner,*
279 U. S. 716, at page 725.

"The function of the court is to decide whether the correct rule of law was applied to the facts found; and whether there was substantial evidence before the Board to support the finding made. * * * Unless the finding of the Board involves a mixed question of law and fact, the court may not properly substitute its own judgment for that of the Board."

Helvering vs. *Rankin,* 295 U. S. 123, 131;
General Utilities & Operating Co. vs. *Helvering,*
296 U. S. 200, 206.

In *Tex-Penn Oil Co.* vs. *Commissioner,* 83 Fed. (2d) 518, the Circuit Court of Appeals set aside a judgment of the Board of Tax Appeals for lack of substantial evidence, and this Court affirmed under the title *Helvering* vs. *Tex-Penn Oil Co.,* 300 U. S. 481. This Court said:

> "The ultimate finding is a conclusion of law or at least a determination of a mixed question of law and fact. It is to be distinguished from the findings of primary, evidentiary or circumstantial facts. It is subject to judicial review and, on such review, the court may substitute its judgment for that of the Board. Helvering *v.* Rankin, 295 U. S. 123."

See also

Jewett & Co. vs. *Commissioner,* 61 Fed. (2d) 471 (Second Circuit);

National Biscuit Company vs. *Federal Trade Commission,* 299 Fed. 733.

Because the Board disregarded the uncontradicted testimony, and drew an evil and nefarious conclusion from a state of facts which established an honest and lawful purpose, its decision was properly reversed. The reports contain many cases in which the Board has disregarded uncontradicted evidence. A few are;

Nichols v. *Comm.,* 44 Fed. (2d) 157 (C. C. A. 3rd);

Chicago Railway Equipment Co. v. *Blair,* 20 Fed. (2d) 10 (C. C. A. 7th);

Planters Operating Co. v. *Comm.,* 55 Fed. (2d) 583 (C. C. A. 8th);

Conrad & Company v. *Comm.*, 50 Fed. (2d) 576 (C. C. A. 1st);
Foster v. *Comm.*, 57 Fed. (2d) 516 (C. C. A. 5th);
Champlin v. *Comm.*, 71 Fed. (2d) 23 (C. C. A. 10th).

Conclusion.

We submit

(1) That it is not within the letter or spirit of Section 104 that it should be applied to *bona fide* business corporations which require large capital as their life blood;

(2) That the uncontradicted evidence shows that petitioner did not have a surplus in excess of the reasonable needs of its business, and did not have the prohibited purpose;

(3) That for its fiscal year ended Jan. 31, 1931 petitioner had no gains—in fact, the depreciation in all its assets was far in excess of the net earnings it reported and on which it paid income taxes.

(4) That had the management of National Grocery Company had any purpose to escape or avoid taxes a legal and proper method was at hand—they could have sold securities and properly taken losses in excess of the profits.

(5) Section 104 of the Revenue Act of 1928 as applied below to Petitioner is clearly unconstitutional,

(a) because it is not an income tax law but provides a penalty for a purpose which is beyond the power of Congress;

(b) It improperly invades the domain of functions reserved to the States by the 10th Amendment;

(c) Since there are no standards set up in the law for the determination of the "reasonable needs of business" for capital either by Directors or the Commissioner, and the penalty may be arbitrarily and capriciously applied by the Commissioner when and upon whom he will, it violates the 5th Amendment;

(d) The law reposes in the Commissioner of Internal Revenue the sole power and authority to determine by standards he alone sets up when and upon whom the penalty is applicable, the Constitution requiring that such standards be placed in the law by Congress.

It is respectfully submitted that for all the reasons aforesaid the judgment of the Circuit Court of Appeals should be affirmed.

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APPENDIX.

Containing a history of legislation attempting to compel distribution of corporate earnings commencing with the Tariff Act of 1913 and including all subsequent legislation on the same subject, testimony concerning the meaning of the law before the Committee investigating the Department of Internal Revenue in 1925, Statement by Secretary Mellon, statements of members of the Congress during debates in the Congress, and reports of congressional committees; and showing how the law has been changed and developed to the Revenue Act of 1936 which imposed a graduated tax on undistributed earnings of corporations at the suggestion of President Roosevelt.

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The Tariff Act of October 3, 1913 (H. R. 3321), Section II, 38 Statutes at Large, p. 166.

SECTION II.

A. Subdivision 1. That there shall be levied, assessed, collected and paid annually upon the entire net income arising or accruing from all sources in the preceding calendar year to every citizen of the United States, whether residing at home or abroad, and to every person residing in the United States, though not a citizen thereof, a tax of 1 per centum per annum upon such income, except as hereinafter provided; and a like tax shall be assessed, levied, collected, and paid annually upon the entire net income from all property owned and of every business, trade, or profession carried on in the United States by persons residing elsewhere.

Subdivision 2. In addition to the income tax provided under this section (herein referred to as the normal income tax) there shall be levied, assessed, and collected upon the net income of every individual an additional income tax (herein referred to as the additional tax) of 1 per centum per annum upon the amount by which the total net income exceeds $20,000 and does not exceed $50,000, and 2 per centum per annum upon the amount by which the total net income exceeds $50,000 and does not exceed $75,000, 3 per centum per annum upon the amount by which the total net income exceeds $75,000 and does not exceed $100,000, 4 per centum per annum upon the amount by which the total net income exceeds $100,000 and does not exceed $250,000, 5 per centum per annum upon the amount by which the total net income exceeds $250,000 and does not exceed $500,000, and 6 per centum per annum upon the amount by which the total net income exceeds $500,000. All the provisions of this section relating to individuals who are to be chargeable with the normal income tax, so far as they are applicable and are not inconsistent with this subdivision of paragraph A, shall apply to the

levy, assessment, and collection of the additional tax imposed under this section. Every person subject to this additional tax shall, for the purpose of its assessment and collection, make a personal return of his total net income from all sources, corporate or otherwise, for the preceding calendar year, under rules and regulations to be prescribed by the Commissioner of Internal Revenue and approved by the Secretary of the Treasury. For the purpose of this additional tax the taxable income of any individual shall embrace the share to which he would be entitled of the gains and profits, if divided or distributed, whether divided or distributed or not, of all corporations, joint-stock companies, or associations however created or organized, formed or fraudulently availed of for the purpose of preventing the imposition of such tax through the medium of permitting such gains and profits to accumulate instead of being divided or distributed; and the fact that any such corporation, joint-stock company, or association, is a mere holding company, or that the gains and profits are permitted to accumulate beyond the reasonable needs of the business shall be prima facie evidence of a fraudulent purpose to escape such tax; but the fact that the gains and profits are in any case permitted to accumulate and become surplus shall not be construed as evidence of a purpose to escape the said tax in such case unless the Secretary of the Treasury shall certify that in his opinion such accumulation is unreasonable for the purposes of the business. When requested by the Commissioner of Internal Revenue, or any district collector of internal revenue, such corporation, joint-stock company, or association shall forward to him a correct statement of such profits and the names of the individuals who would be entitled to the same if distributed.

When Section II of the Tariff Act of 1913 was considered in the Senate (See Congressional Record-Senate—1913, Vol. 50, p. 4380) the following discussion occurred with respect to the provision in the income tax law taxing undistributed corporate gains and profits.

"Mr. Warren: Mr. President, may I ask the Senator a question? That alludes to profits in a corporation that are not divided?

Mr. Williams: Yes.

Mr. Warren: What would be the construction where a business is of such a nature that the risks are such that they are in the habit of going along for two or three——

Mr. Williams: This does not apply to all profits that are not divided at all. It applies only to such profits and the heaping up of such surplus as shall justify the Secretary of the Treasury in concluding that it is done for the purpose of evading the tax. Its main purpose is to prevent the formation of holding companies.

Here is a man, for example, with an income as large as Mr. Carnegie's income, let us say. There would be nothing to prevent him from organizing a holding company and passing his income from year to year up to undivided profits. I think if the Senator will watch the reading of the amendment he will understand its object."

* * * * * *

"Mr. Brandegee: It gives the Secretary of the Treasury absolute power to say exactly what surplus shall be in his opinion proper for the conduct of any business, and if the views of the managers of the business do not coincide with his views they are guilty of a fraud.

Mr. Williams: Somebody has to sit in judgment as to whether there is a fraud or not.

Mr. Brandegee: I should think that it is a very dangerous amendment."

Revenue Act of September 8, 1916 (H. R. 16763), Title I, Part I, 39 Statutes at Large, p. 758.

ADDITIONAL TAX INCLUDES UNDISTRIBUTED PROFITS.

SEC. 3. For the purpose of the additional tax, the taxable income of any individual shall include the share to which he would be entitled of the gains and profits, if

divided or distributed, whether divided or distributed or not, of all corporations, joint-stock companies or associations, or insurance companies, however created or organized, formed or fraudulently availed of for the purpose of preventing the imposition of such tax through the medium of permitting such gains and profits to accumulate instead of being divided or distributed; and the fact that any such corporation, joint-stock company or association, or insurance company is a mere holding company, or that the gains and profits are permitted to accumulate beyond the reasonable needs of the business, shall be prima facie evidence of a fraudulent purpose to escape such tax; but the fact that the gains and profits are in any case permitted to accumulate and become surplus shall not be construed as evidence of a purpose to escape the said tax in such case unless the Secretary of the Treasury shall certify that in his opinion such accumulation is unreasonable for the purposes of the business. When requested by the Commissioner of Internal Revenue, or any district collector of internal revenue, such corporation, joint-stock company or association, or insurance company shall forward to him a correct statement of such gains and profits and the names and addresses of the individuals or shareholders who would be entitled to the same if divided or distributed.

Revenue Act of February 24, 1919, (Cited as Revenue Act of 1918) (H. R. 12863), Title II, 40 Statutes at Large 1072.

PROFITS OF CORPORATIONS TAXABLE TO STOCKHOLDERS.

SEC. 220. That if any corporation, however created or organized, is formed or availed of for the purpose of preventing the imposition of the surtax upon its stockholders or members through the medium of permitting its gains and profits to accumulate instead of being divided or distributed, such corporation shall not be subject to the tax

imposed by section 230, but the stockholders or members thereof shall be subject to taxation under this title in the same manner as provided in subdivision (e) of section 218 in the case of stockholders of a personal service corporation, except that the tax imposed by Title III shall be deducted from the net income of the corporation before the computation of the proportionate share of each stockholder or member. The fact that any corporation is a mere holding company, or that the gains and profits are permitted to accumulate beyond the reasonable needs of the business, shall be prima facie evidence of a purpose to escape the surtax; but the fact that the gains and profits are in any case permitted to accumulate and become surplus shall not be construed as evidence of a purpose to escape the tax in such case unless the Commissioner certifies that in his opinion such accumulation is unreasonable for the purposes of the business. When requested by the Commissioner, or any collector, every corporation shall forward to him a correct statement of such gains and profits and the names and addresses of the individuals or shareholders who would be entitled to the same if divided or distributed, and of the amounts that would be payable to each.

Revenue Act of November 23, 1921 (H. R. 8245), Title II, 42 Statutes at Large, p. 247.

EVASION OF SURTAXES BY INCORPORATION.

SEC. 220. That if any corporation, however created or organized, is formed or availed of for the purpose of preventing the imposition of the surtax upon its stockholders or members through the medium of permitting its gains and profits to accumulate instead of being divided or distributed, there shall be levied, collected, and paid for each taxable year upon the net income of such corporation a tax equal to 25 per centum of the amount thereof, which shall be in addition to the tax imposed by section 230 of this title

and shall be computed, collected, and paid upon the same basis and in the same manner and subject to the same provisions of law, including penalties, as that tax: *Provided,* That if all the stockholders or members of such corporation agree thereto, the Commissioner may, in lieu of all income, war-profits and excess-profits taxes imposed upon the corporation for the taxable year, tax the stockholders or members of such corporation upon their distributive shares in the net income of the corporation for the taxable year in the same manner as provided in subdivision (a) of section 218 in the case of members of a partnership. The fact that any corporation is a mere holding company, or that the gains and profits are permitted to accumulate beyond the reasonable needs of the business, shall be prima facie evidence of a purpose to escape the surtax; but the fact that the gains and profits are in any case permitted to accumulate and become surplus shall not be construed as evidence of a purpose to escape the tax in such case unless the Commissioner certifies that in his opinion such accumulation is unreasonable for the purposes of the business. When requested by the Commissioner, or any collector, every corporation shall forward to him a correct statement of such gains and profits and the names and addresses of the individuals or shareholders who would be entitled to the same if divided or distributed, and of the amounts that would be payable to each.

Report of the Committee on Ways and Means of the House of Representatives to accompany H. R. 8245 (Revenue Act of 1921).

SURTAX EVASION BY CORPORATE ORGANIZATION.

Section 226: Section 220 of the existing law provides that if any corporation is formed or availed of for the purpose of evading the surtax upon its stockholders through the medium of permitting its gains and profits to accumu-

late instead of being divided, the stockholders shall be taxed in the same manner as partners. By reason of the recent decision of the Supreme Court in the stock dividend case (*Eisner* v. *Macomber*, 252 U. S. 189), considerable doubt exists as to the constitutionality of the existing law. Section 226 of the bill therefore proposes to amend section 220 of the existing law so as to impose upon corporations of the character above described a flat additional income tax of 25 per cent of the net income; but if the stockholders agree, they may be taxed upon their distributive shares in the net income of the corporation in the same manner as members of a partnership, such taxes to be in lieu of all income taxes upon the corporation.

Congressional Record—House—1921
Volume 61, p. 5203.

Mr. Hawley:—"Section 226 is to prevent the formation of corporations for the purpose of preventing the imposition of the surtax upon their stockholders or members. Such corporations were formed in the endeavor to evade the law. We provide legislation by which that will be prevented in the future."

(Note: Mr. Hawley was a member of the Ways and Means Committee and was speaking in explanation of H. R. 8245. Section 226 of H. R. 8245 became Section 220 of the Revenue Act of 1921.)

Revenue Act of June 2, 1924 (H. R. 6715), Title II,
43 Statutes at Large, p. 277.

EVASION OF SURTAXES BY INCORPORATION.

SEC. 220. (a) If any corporation, however created or organized, is formed or availed of for the purpose of preventing the imposition of the surtax upon its shareholders

through the medium of permitting its gains and profits to accumulate instead of being divided or distributed, there shall be levied, collected, and paid for each taxable year upon the net income of such corporation a tax equal to 50 per centum of the amount thereof, which shall be in addition to the tax imposed by section 230 of this title and shall (except as provided in subdivision (d) of this section) be computed, collected, and paid upon the same basis and in the same manner and subject to the same provisions of law, including penalties, as that tax.

(b) The fact that any corporation is a mere holding or investment company, or that the gains or profits are permitted to accumulate beyond the reasonable needs of the business, shall be prima facie evidence of a purpose to escape the surtax.

(c) When requested by the Commissioner, or any collector, every corporation shall forward to him a correct statement of such gains and profits and the names and addresses of the individuals or shareholders who would be entitled to the same if divided or distributed, and of the amounts that would be payable to each.

(d) As used in this section the term "net income" means the net income as defined in section 232, increased by the sum of the amount of the deduction allowed under paragraph (6) of subdivision (a) of section 234, and the amount of the interest on obligations of the United States issued after September 1, 1917, which would be subject to tax in whole or in part in the hands of an individual owner.

Secretary Mellon before the Committee on Finance of the United States Senate on H. R. 6715 (Revenue Act of 1924), April 3, 1924, said of Section 220 (at page 293):

> "Secretary Mellon: You take an individual organizing a corporation and putting his holdings in it, which immediately raises the presumption that that is what it is done for.

The other class of corporation, the class like the Standard Oil Co., is different. They are organized to carry on business; they are developing the business. There is a growth to the business, and that section 220 does not apply to them. The general situation which you speak of does not exist. I do not mean to say that there are not some isolated cases, but they are few.

Senator Jones of New Mexico: The inducement there is just the same, is it not?

Secretary Mellon: No; because there is the penalty that takes away the inducement; there is a penalty of 25 per cent on any corporation that does that. You have to apply 25 per cent penalty in addition to the tax; so that no one would think of it.

Senator Jones of New Mexico: As I said awhile ago, it would be a very dull person who would organize a corporation in such a way as to come within the penalty of that section of the statute.

Secretary Mellon: Personally, I would not know how to do it myself; I do not believe it could be accomplished."

When Section 220 of the Revenue Act of 1924 was being considered in the Senate, the following discussion occurred (Congressional Record—Senate—Vol. 65, pages 7154, 7155, 7356, 7358 and 7359):

"Mr. Jones of New Mexico: The history of that section is well known to all of us who have been following revenue legislation. A provision of that sort was put into the first revenue bill in 1917 just as we were entering the war, and some Senators may recall that I predicted at that time that it would be, for all practical purposes, ineffective.

Senators will observe that the section only applies to cases where the corporation is organized for the purpose of evading surtaxes. The purpose of an individual in doing anything is always very difficult to prove.

Mr. McKellar: If the Senator will permit me to interrupt him, it is specifically provided that:

'The fact that * * * the gains or profits are permitted to accumulate beyond the reasonable needs of the business shall be *prima facie* evidence of a purpose to escape the surtax.'

That should be broad enough, I think, to cover any corporation whose gains and profits were so great that it was necessary to declare a stock dividend.

Mr. Jones of New Mexico: That provision has been in the law since 1917. The Senator from Tennessee is a lawyer and the Senator from South Carolina as well is a lawyer. I think it is understood by all lawyers that in organizing a corporation, in specifying the purposes for which the corporation is organized, the charter is made exceedingly broad; in fact, it is customary now, I think, to include in the charters of all corporations provisions which will enable them in effect to engage in any legal enterprise or industry. When can it be said that a corporation is retaining its earnings unduly or beyond the reasonable necessities of the business, when the corporation is permitted to engage in any legitimate industry? There are many corporations organized specifically for the purpose of investing and reinvesting earnings. That is a legitimate enterprise. Many people who are engaged in the investment business do it through the agency of a corporation because of the convenience of doing business, because of the limited liability attaching to the activities in the name of a corporation rather than as an individual.

Many people organize a corporation for the purpose of transferring their individual assets to it, so as to ease the matter of distribution in event of death. It is much easier to distribute to the heirs of an estate the proper share of the estate if it is a corporation, and you are merely dealing with shares of stock, than it is to divide the actual corpus of the estate, the personal property, the real estate, and have ownership in different heirs by inheritance or devise. So as a matter of convenience corporations are often organized for the purpose of an easy way of handling the estate upon death. As long as the purpose of the corporation is to be inquired into as a condition precedent to the imposition of a penalty

it will never amount to anything in my opinion." (pp. 7154-7155.)

* * * * * * *

Mr. McKellar: As I understand the purpose of section 220, it is to prevent an individual from putting his or her property in the hands of a corporation and thereby escaping the higher brackets of the income tax and simply paying a corporation tax of 12½ per cent. That is the general purpose of the provision, is it not?

Mr. Jones of New Mexico: The purpose of the provision is to prevent that; and I will say to the Senator, while I do not like to indulge in comment on purposes in enacting legislation, I think I can tell the Senator a little history which will clarify this matter in his mind.

Mr. McKellar: I should be very glad if the Senator from New Mexico would do so.

Mr. Jones of New Mexico: In 1917 I proposed to put a provision in the bill then pending to tax undistributed incomes of corporations.

Mr. McKellar: Yes; I remember it very well.

Mr. Jones of New Mexico: In the bill as first reported to the Senate the Finance Committee adopted that provision; but in the meantime, because of additional calls upon Congress for funds by the War Department, the bill went back to the committee, and persons in control of the corporations who did not want that thing done commenced pouring in their protests against it. So the majority of the Finance Committee opposed such a tax and put this provision in so that they could say that there was a provision in the bill to prevent the evasion of surtaxes. As I predicted then, however, and still predict, it will have no such effect.

Mr. McKellar: The letter of the Secretary of the Treasury, which was written, as I recall, in January or February last, specifically states that there has been no attempt to enforce the provision, but the Secretary stated at that time—if the Senator from South Carolina will permit me to interrupt him further——

Mr. Dial: Certainly.

Mr. McKellar: The Secretary of the Treasury stated at that time that an amendment would be offered to this section which would so improve it as to cause section 220 to have the desired effect. What I wish to know from the Senator is whether any such proposal was made. Apparently section 220 is as nugatory in the pending bill as it was in the last one.

Mr. Jones of New Mexico: Mr. President, I may say that I undertook to test the real sentiment of the majority of the committee upon that question, and moved to strike out the words "for the purpose of" on page 69, line 5, so that where corporations were formed or availed of so as to evade the surtaxes a remedy might be provided, but every member of the majority side of the committee, as I expected, opposed the motion which I had made, showing that there is no expectation through this section of preventing corporations being availed of whether for one purpose or another so as to evade the high surtaxes." (p. 7155.)

"Mr. Simmons: The Secretary ought to have attacked it from the standpoint that the creation of this new species of corporations was for the purpose of evading taxes and that such corporations were void and ineffective as accomplishing that purpose, and he should have sought to impose upon them the same tax upon that income that would have been imposed upon it in the hands of the original corporation. That is the angle from which he ought to have attacked it.

Mr. Norris: Yes.

Mr. Simmons: Now, all sorts of devices are resorted to frequently to escape burdens or to escape indebtedness. We have an instance of that in the case of some debtors. Sometimes debtors seek by fraudulent transfers of their property and other fraudulent devices to escape their indebtedness; but the courts will look behind such transactions and will ascertain what was the motive of the transaction, and if it would accomplish a fraud, it is a void transaction as to the debtor. So if these corporations are flagrantly and deliberately created for the sole purpose—and that seems to be the Secretary's idea, and

that seems to be the fact—for the sole purpose of evading taxes due the Government, then they are fraudulent concerns.

Mr. Norris: I should think so.

Mr. Simmons: The courts would look behind them, and if they found that they were in fraud of the Government they would hold them to be ineffective, and that their income should be charged against them just as it should be charged against the original corporation." (P. 7356.)

* * * * * * *

"Mr. Jones: * * * In the consideration of the bill passed in 1917, this question was discussed at length, and under the laws of practically all of the States in the Union you may organize a corporation for almost any lawful purpose. In my State the law specifically provides that you may organize a corporation for any lawful purpose, and we all know that the charters of most corporations are just as broad as the imagination can make them. It costs no more to have your charter broad, so that you may engage in any kind of lawful business. The investment business is a lawful business. The holding of properties and assets is a lawful business, and under this provision you can not prevent the organization of these corporations, which will as a matter of fact be availed of, so that the result will be to take away the possibility of collecting surtaxes on these large incomes. That is just as inevitable as that the sun will rise tomorrow. You can not say that a man is organizing a corporation for the purpose of evading taxation, when he has a legal right to do the thing which he is attempting to do." (P. 7358.)

* * * * * * *

"Mr. King: I would like to ask the Senator from Nebraska what proof would be required to determine what are "the reasonable needs of business?" The able Senator from Utah (Mr. Smoot), the chairman of the committee, has contended very forcefully, that each corporation ought to have a large reserve, a large surplus. Many wise business men insist upon an enormous surplus. Others insist upon a reduced

surplus, and there is very wide ground there for a divergence of opinion as to what would be a reasonable surplus. There are no guides prescribed in the statute to determine, and there is the discretion which is allowed the executive officers.

Mr. Norris: That is true. That may be a place where an amendment should be made, if anybody can suggest an amendment which would take away or decrease that broad discretion allowed. Of course, if a corporation were organized purely as an investment company, and for nothing else, that discretion would not exist; but the second part of the proposition, as to the amount which it would be reasonable to keep on hand, is a very broad proposition. If there is any way to amend the bill and make it more concrete, it seems to me we ought to do it. I want to see this remedied." (P. 7359.)

In 1925 a Select Committee on Investigation of the Bureau of Internal Revenue, 68th Congress, held hearings and took testimony. There was present on behalf of the Bureau of Internal Revenue, Mr. C. R. Nash, Assistant to the Commissioner, and Mr. A. W. Gregg, Solicitor of the Bureau.

Mr. Gregg and Mr. Manson testified before the Committee on May 27, 1925, concerning Section 220 of the Acts of 1921 and 1924 (being substantially the same as Section 104 of the Act of 1928) as follows:

"Mr. Gregg: Take the cases to which it was intended to apply. The taxpayer, his wife and children, transfer all of their stock to a corporation. The corporation, which they have organized just for that purpose, receives the dividends on this stock, and distributes none of the dividends. Thus the members of the family, the taxpayer and his wife and children, avoid the payment of a surtax.

The Chairman: Was that the only case it was intended to get at?

Mr. Gregg: No; it is not the only case, but it is the case that it was primarily aimed at." (Page 3835.)

"Mr. Manson: When I first became connected with this committee it was in the capacity of statistician, and in preparing the questionnaire for information I had section 220 of the acts of 1921 and 1924 under consideration. The questionnaire was prepared with the view to bringing out such information as would throw light upon both the administration of section 220 and the economic questions involved in section 220. * * *

This section probably delegates to the commissioner more authority, more discretion, which would be of vital consequence to the taxpayers of the country generally than any other section of the income tax law. Among other things, it delegates to the commissioner the right to determine whether or not accumulations of earnings are reasonably necessary for the conduct of the corporate business. That, in effect, gives to the commissioner, if he chooses to exercise that authority to the full extent delegated by Congress, a right to review the financial managements and to act as a sort of an appellate court over the board of directors in determining the financial policy of every corporation in the United States. * * *

Senator Watson: Does anybody but an expert know what section 220 means?

Mr. Manson: Well, I am going to state some of the problems that arise out of it. I am not prepared to say now what, in my judgment, it means. * * *

Senator Watson: I am not so much interested in that as I am in knowing how, if at all, section 220 can be simplified. The Committee on Finance had that question up, as Mr. Gregg will remember. We went over it, and after we had wrestled with it time and again, on many occasions, we all came to the conclusion that we did not know what it meant, and let it go in.

Mr. Manson: Well, I do not blame you.

Senator Watson: Of course, Mr. Gregg understood it.

Mr. Gregg: I never claimed to.

Senator Watson: Well, but we thought you did. At least, you gave the only explanation of it that anybody ever did. Doctor Adams went over it, and,

of course, we had great respect for his knowledge and ability. I talked with him privately about it and we were trying to see if there was not some way in which it could be simplified, so that the wayfaring man, though a fool, need not err therein, but found that it could not be done. The problems with which it dealt were, in their nature, so abstruse and complex that the language dealing with those problems, of necessity, could not be expressed plainly and simply, as was the case with the other tax sections.

I might say in connection with my statement that the members of the Finance Committee did not know what it meant or were not able to come to a conclusion about it—was too drastic and sweeping. We all had our ideas about what it meant, of course'' (pp. 3844 and 3845 of the Investigation).

(Beginning at the bottom of p. 3848):

''Mr. Manson: This section makes a holding company or an investment company which accumulates its profits, *prima facie* evidence; that is, in the case of a holding company or investment company, the fact that it is a holding company or an investment company is *prima facie* evidence of an attempt to defeat the surtax, provided the company accumulates its profits.

Right there you have a problem. There are some cases which will come clearly within section 220. There are some cases that come clearly outside of it. The vast number come between those two.

Let me illustrate: A large New York bond house is incorporated. It accumulates very large business profits of earnings. The business of this corporation is the underwriting of bond issues and the sale of those bond issues to the public.

It can not be said that that corporation is a mere holding company, because it is engaged in the very active business of buying and selling bonds. It can not be said, no matter to what extent it accumulates its earnings, that those earnings are not required for the corporate business, because there is no year in which that corporation, notwithstanding the amount that it accumulates, is not required to go to the banks

and borrow money for the purpose of financing the underwriting of bonds.

As long as a corporation is doing a business which requires it to borrow money from the banks it is certainly impossible for the department to say that it does not need its own money.

There is a case that comes clearly outside of the operation of this section. That corporation has at times idle capital. That capital has not been permitted to remain in cash. They carry the bonds and stocks to keep that capital working while it is not required for the regular business of the corporation.

We have at the other end of the line, as it were, the case of an individual who owns several million dollars of stock. There is no change in his holdings. He organizes a corporation to hold his stock. The only purpose of that corporation is to collect the dividends and accumulate them.

There is a clear case that comes under the application of this section.

The regulation adopted in construing this section confined the application of the section to the latter class of cases.

Section 220 of the statutes is designed to discourage the formation or use of a corporation for the purpose of preventing the imposition of surtaxes upon the stockholders, through the device of permitting its gains and profits to accumulate instead of being distributed."

(At page 3852):

"Senator Jones of New Mexico: Yes; and I stated at the time that the section would never have any practical effect, and I do not believe it has had. The thing to do is to try to equalize or to do away with the disparity in taxation as between individuals and corporations. That is the only remedy that I know of for the problem.

Mr. Manson: In my judgment, such judgment as I have, the section is founded upon an economic fallacy, and attempts to treat the symptom of a weakness in the system of taxation. I am not prepared to say that this section is not a good policeman, to use an expression that I heard the chairman use this

morning; in other words, that the fear of the application of it may not be a deterrent; but I can see where the section itself is so weak that anyone who is at all clever can get around it, without the least bit of trouble."

(At page 3857):

"Senator Jones of New Mexico: I was just wondering whether any special attention has been given to the constitutionality of the statute against a corporation being availed of.

Take that particular case. There is a corporation which existed and was doing business. It is winding up its affairs. The result is that the taxpayer does not pay much tax, but what right has the Government, in the exercise of the power to tax income, to force a corporation to distribute its earnings? I do not see how you can question that transaction, or reach it, rather, other than through a tax upon the corporation itself.

Mr. Gregg: Of course, section 220 applies to the corporation itself, Senator.

Senator Jones of New Mexico: But how can you, in the absence of some provision for taxing a corporation, say that that is a fraud upon the Government?

Mr. Gregg: We do not have to say it is fraud, if it is——

Senator Jones of New Mexico: I know; but the intent to avoid taxation is what you reach, and how can you say that that is such an attempt? For aught we know or can tell, they keep the assets of the corporation; they may want to invest them some other way in the name of the corporation.

Mr. Gregg: Under the statute we do not even have to go to intent.

Senator Jones of New Mexico: I wonder, from a constitutional standpoint, how you can apply it to a thing of this sort.

Mr. Gregg: The constitutionality has been questioned. It seems to me that we can go rather far in prohibiting, by attacks on the corporation itself, a tax on the income of the corporation, this attempt to

evade taxes. We can go pretty far in preventing such action.

Senator Watson: You mean a penalty?

Mr. Gregg: Yes, sir; it is called a tax. It does not say it is a penalty. It is a penalty, however.

Senator Watson: It is a penalty?

Mr. Gregg: Yes.

Senator Jones of New Mexico: Under existing law the only object or any other result that could have been brought about other than that which happened in through requiring that this corporation declare dividends. I do not think you can require a corporation, for taxation purposes, to do anything.

Mr. Gregg: You can not do that.

Senator Jones of New Mexico: You have to meet the situation that the law itself covers and impose a tax. I do not see anything in the present law which would impose a tax under the circumstances here, if it were organized with the intent of doing this thing and using it, and so on, that is one thing."

(At page 3859):

"Senator Jones of New Mexico: That company was doing a legitimate business. It received these stocks and bonds in payment for its property, and of course collected the dividends and coupons on its stocks and bonds. Now, to say, that that is availed of would be to force a corporation to a distribution of its dividends.

I quite agree that we can reach the matter, but not through the provisions of section 220. We can reach it by imposing upon the dividends received by that corporation a tax on what is undistributed, and it there becomes a tax upon income. * * *

Senator Jones of New Mexico: I do not see how you can compel a distribution of assets under an authority to tax income.

Mr. Manson: I do not, either; but suppose you attempted to impose a penalty here, because they did not under the income tax law? They might be able to come in and show that they were not holding this property to escape tax, because they expected the market on General Motors stock to go up, and that

the market conditions were unfavorable, and that they wanted to hold that stock until the market on General Motors improved. That would be a perfectly legitimate reason.

Senator Jones of New Mexico: And they might want to use this corporate entity here for the purpose of engaging in some other line of business."

(At page 3866):

"Senator Jones of New Mexico: If the charter is broad enough to include the different businesses, how can the Commissioner of Internal Revenue restrict it to one line of industry?

Mr. Manson: Under such circumstances, of course, as applied to manufacturing companies and things of that sort, there is no force or effect to the statute whatever.

If the statute is to be construed as permitting the commissioner discretion, I point out an illustration of that kind to show the vast amount of discretion, and to show that questions are raised that are far more troublesome than any that we have ever presented to this committee in all the work that we have done from the time that we began to hold hearings."

Revenue Act of February 26, 1926 (H. R. 1), Title II, 44 Statutes at Large, part II, p. 34.

EVASION OF SURTAXES BY INCORPORATION.

SEC. 220. (a) If any corporation, however created or organized, is formed or availed of for the purpose of preventing the imposition of the surtax upon its shareholders through the medium of permitting its gains and profits to accumulate instead of being divided or distributed, there shall be levied, collected, and paid for each taxable year upon the net income of such corporation a tax equal to 50 per centum of the amount thereof, which shall be in addition to the tax imposed by section 230 of this title and shall (except as provided in subdivision (d) of this section) be

computed, collected, and paid upon the same basis and in the same manner and subject to the same provisions of law, including penalties, as that tax.

(b) The fact that any corporation is a mere holding or investment company, or that the gains or profits are permitted to accumulate beyond the reasonable needs of the business, shall be *prima facie* evidence of a purpose to escape the surtax.

(c) When requested by the Commissioner, or any collector, every corporation shall forward to him a correct statement of such gains and profits and the names and addresses of the individuals or shareholders who would be entitled to the same if divided or distributed, and of the amounts that would be payable to each.

(d) As used in this section the term "net income" means the net income as defined in section 232, increased by the sum of the amount of the deduction allowed under paragraph (6) of subdivision (a) of section 234, and the amount of the interest on obligations of the United States issued after September 1, 1917, which would be subject to tax in whole or in part in the hands of an individual owner.

(e) The tax imposed by subdivision (a) of this section shall not apply in respect of any taxable year if all the shareholders of the corporation include (at the time of filing their returns) in their gross income their entire distributive share, whether distributed or not, of the net income of the corporation for such year. Any amount so included in the gross income of a shareholder shall be treated as a dividend received. Any subsequent distribution made by the corporation out of the earnings or profits for such taxable year shall, if distributed to any shareholder who has so included in his gross income his distributive share, be exempt from tax in the amount of the share so included.

In the **report of the Joint Committee on Internal Revenue taxation to the Committee on Ways and Means of the House of Representatives, and the Committee on Finance of the Senate, dated November 15, 1927,** it is stated, regarding Section 220:

> "A careful investigation of this subject and of individual cases which appear to come within the scope of the provision has been made, resulting in the conclusion that the present statute is obscure and difficult of administration. The provision has been effective only in so far as it has deterred the formation of personal holding companies or has stimulated distributions.
>
> The two greatest difficulties facing the administration in applying the present provision consist, first, in proving the 'purpose' to evade, and, second, in proving what constitutes 'the reasonable needs of the business.' The evidence necessary to prove the first point is almost always unobtainable, and the definition of the reasonable needs of a business, required in the second case, is generally beyond the power of the bureau, at least, in the case of operating companies.
>
> The incentive to incorporate in order to avoid surtaxes has largely disappeared."

The report contained the following recommendation:

> "7. A change in the act is recommended which will automatically encourage reasonable distribution of dividends without causing unwise distributions and which will make the retention of section 220 unnecessary."

Under the discussion of the recommendation was the following:

> "It is extremely difficult for the Bureau of Internal Revenue effectively to enforce the provisions of section 220.
>
> The principal difficulty arises from the fact that section 220 is necessarily vague in its terms. The test of its application (except in cases of mere holding and investment companies) is whether the ac-

cumulations of income are beyond the reasonable needs of the business. The intent of the statute on this point is clear, but the difficulty of determining the facts in most cases is extremely great. The needs of a business depend largely on the intention of its owners in regard to its development. In deciding such cases long after the event, the commissioner is called upon to substitute his business judgment as to the prospective needs of an enterprise at a given date for the current judgment of those responsible for the conduct of the business. In some industries, such as banking, the reasonable needs of the business appear to be limited only by the imagination of the directors. A more specific definition of the test to be applied which will work out satisfactorily in all cases seems well-nigh impossible. Arbitrary rules setting up certain required percentages of distribution in relation to total income or total surplus are obviously unsatisfactory, because of the fact that no two corporations are similarly situated. The problem is very much more difficult than determination of reasonable salaries, reasonable allowances for depreciation, and similar problems.

The second difficulty is the requirement that the Bureau of Internal Revenue find in all cases (except in those involving mere holding and investment companies) the existence of 'a purpose to' evade surtax on the part of the taxpayer. This not only involves the determination of motive or purposes which is particularly difficult in the case of a corporation since corporate action is determined by the board of directors or the principal stockholders or some of them, but involves a consideration of the various purposes which may have influenced the judgment of the various individuals who determined the action of the corporation."

The Committee ended its report as follows:

"The joint committee approves in principle the recommendations in Volume I except those relating to section 220, and the provisions relating to the expense of transfers in the field service, which it neither approves nor disapproves."

Revenue Act of May 29, 1928 (H. R. 1), Title I, 45 Statutes at Large, p. 814.

SEC. 104. ACCUMULATION OF SURPLUS TO EVADE SURTAXES.

(a) If any corporation, however created or organized, is formed or availed of for the purpose of preventing the imposition of the surtax upon its shareholders through the medium of permitting its gains and profits to accumulate instead of being divided or distributed, there shall be levied, collected, and paid for each taxable year upon the net income of such corporation a tax equal to 50 per centum of the amount thereof, which shall be in addition to the tax imposed by section 13 and shall be computed, collected, and paid upon the same basis and in the same manner and subject to the same provisions of law, including penalties, as that tax.

(b) The fact that any corporation is a mere holding company, or that the gains or profits are permitted to accumulate beyond the reasonable needs of the business, shall be prima facie evidence of a purpose to escape the surtax.

(c) As used in this section the term "net income" means the net income as defined in section 21, increased by the sum of the amount of the dividend deduction allowed under section 23(p) and the amount of the interest on obligations of the United States issued after September 1, 1917, which would be subject to tax in whole or in part in the hands of an individual owner.

(d) The tax imposed by this section shall not apply if all the shareholders of the corporation include (at the time of filing their returns) in their gross income their entire distributive shares, whether distributed or not, of the net income of the corporation for such year. Any amount so included in the gross income of a shareholder shall be treated as a dividend received. Any subsequent distribution made by the corporation out of the earnings or profits

for such taxable year shall, if distributed to any shareholder who has so included in his gross income his distributive share, be exempt from tax in the amount of the share so included.

When Section 104 of the Revenue Act of 1928 was being considered in the House, Mr. Garner (now Vice President of the United States) who was a member of the Committee on Ways and Means made the following statement (Congressional Record—House—1927, Volume 69, page 519):

> "I am sure you will remember what section 220 in the present law is. It was intended to enable the Secretary of the Treasury to force corporations to distribute their profits and subject their shareholders to the tax levied by Congress. It has been in the statute for some years."

Representative Green of Iowa said, page 521:

> "You will not find much direct revenue raised by this provision but the effect will be to dissolve a number of these corporations that were formed to escape the surtax, and the persons who own them will pay their surtax in the regular way, the same as other people. That will be the effect. * * *
>
> I am told by gentlemen familiar with the operations of these corporations and gentlemen connected with large accounting firms and others that section 220 of the present law, while it never brought in any revenue, operated in such a way as to cause a great many of these corporations to dissolve. It has been, in fact, a most excellent scarecrow if it has been nothing else, and it has driven these people into taking such action as to avoid the penalties prescribed."

During the discussion of section 104 of the Revenue Act of 1928 in the Senate in 1928, Senator Smoot made the following statement (Congressional Record—Senate—1928 Volume 69, page 7976):

"I am not certain that the limitations found in section 105, pages 68 and 69, of the pending bill are a sufficient curb or guide to the Secretary of the Treasury in exercising the great discretion allowed him in dealing with this question of reserves.

The Secretary alone is to determine, if I interpret the section correctly, what would be a proper reserve or accumulation, before the penalty of 50 per cent is applied. One Secretary of the Treasury or one Federal official connected with the revenue branch of the Government might regard a certain amount of reserve or surplus as proper. A different rule might be prescribed by his successor."

Senator King said (pp. 7976 and 7977):

"How much shall be allowed as a surplus before the penalty shall be applied? I do not know. Should we attempt to circumscribe those engaged in business and limit the amount of reserves and accumulations before the penalty of 50 per cent is applied, or should the entire matter be committed to the discretion of those administering the law?

I am not satisfied with this section, and yet I am not in position to offer an amendment to supersede it. The Finance Committee considered the House amendment, which was intended to clarify the situation; and I think that after due consideration the committee reached the conclusion that instead of clarification it would add to the uncertainty and dubiety if attempts were made to prescribe the limitation upon the amount allowed as reserves and the circumstances under which such reserves should be set up.

MR. SIMMONS: Mr. President, I think Senators on this side agree with the general propositions laid down by the Senator from Utah. We have criticised this provision in the present law ever since it was enacted. We have recognized the fact that it lodged almost unlimited discretion in the Secretary of the Treasury; and we have complained bitterly that for many years after its original enactment the Secretary of the Treasury did not exercise that discretion at all, but permitted these surpluses to be accumulated in gigantic sums, without taking any action to force their distribution.

In all of our discussions about this question, however, we have all realized the fact that sound economy in the conduct of a business by a corporation made it necessary that they should set aside a certain part of their annual earnings for purposes of enlargement, for purposes of improvement of their methods and their equipment, and that the requirements of one class of corporations in this respect were different from those of another class of corporations; that it was almost impossible to lay down any fixed rule to regulate the distribution of these accumulated surpluses which would not be to the disadvantage of some and to the advantage of other corporations. In that state of inability to adjust what the several corporations of the country might legitimately and reasonably require in order to be upon a safe footing in the conduct of their business, and to enlarge and develop their business and improve their methods, we felt that we were hopeless unless the Secretary of the Treasury would enforce this provision of the law.

I know that both sides of the Finance Committee have sought to devise some method that might place safeguards around an unwise exercise of discretion on the part of the Secretary of the Treasury, or might coerce him to enforce the law; but I confess that neither side of the committee up to this time has been able to suggest any satisfactory solution of that problem. To my mind, the House provision is not a satisfactory solution of it; and the exigencies created in the present condition of things with respect to this matter are nothing like so urgent, nothing like so great and important, as they were when taxes were higher than they are now."

Regulations 74, Relating to Taxes Under 1928 Law (pp. 155 to 157 inc.).

Art. 541. TAXATION OF CORPORATION UTILIZED FOR EVASION OF SURTAX.—Section 104 is designed to discourage the formation or use of a corporation for the purpose of preventing the imposition of surtaxes upon its shareholders,

through the device of permitting its gains and profits to accumulate instead of being distributed. If a domestic or foreign corporation is so formed or availed of, it is subject to a tax at the rate of 50 per cent upon its net income in addition to the tax imposed by section 13. However, the additional tax at the rate of 50 per cent does not apply for 1928 or any subsequent taxable year if all the shareholders of the corporation include (at the time of filing their returns) in their gross income their entire distributive share, whether distributed or not, of the net income of the corporation for such year or years. Any amount so included in the gross income of a shareholder shall be treated as a dividend received, and any subsequent distribution made by the corporation out of the earnings or profits for such taxable years shall, if distributed to any shareholder who has so included in his gross income his distributive share, be exempt from tax in the amount of the share so included.

Art. 542. PURPOSE TO ESCAPE SURTAX.—Prima facie evidence of a purpose to escape the surtax exists where a corporation is a mere investment company, where a corporation has practically no business except holding stocks, securities, or other property and collecting the income therefrom or investing therein, or where a corporation other than a mere holding or investment company permits its gains and profits to accumulate beyond the reasonable needs of the business. The statutory presumption that a mere holding or investment company is subject to the additional tax imposed by section 104 may be overcome if the corporation can show, either by reason of the fact that it distributed a large portion of its earnings for the year in question, or that its stock was held not by the members of a family or of a small group but by a large number of persons and in comparatively small blocks, or by other evidence, that it was not availed of for the purpose of preventing the imposition of the surtax upon its shareholders.

The business of a corporation is not merely that which it has previously carried on, but includes in general any line

of business which it may legitimately undertake. However, a radical change of business when a considerable surplus has been accumulated may afford evidence of a purpose to escape the surtax. When one corporation owns the stock of another corporation in the same or a related line of business and in effect operates the other corporation, the business of the latter may be considered in substance the business of the first corporation. Gains and profits of the first corporation put into the second through the purchase of stock or otherwise may therefore, if a subsidiary relationship is established, constitute employment of the income in its own business. To establish that the business of one corporation can be regarded as including the business of another it is ordinarily essential that the first corporation own substantially all of the stock of the second. Investment by a corporation of its income in stock and securities of another corporation is not without anything further to be regarded as employment of the income in its business.

Art. 543. UNREASONABLE ACCUMULATION OF PROFITS.—An accumulation of gains and profits is unreasonable if it is not required for the purposes of the business, considering all the circumstances of the case. It is not intended, however, to prevent reasonable accumulations of surplus for the needs of the business. No attempt can be made to enumerate all the ways in which gains and profits of a corporation may be accumulated for the reasonable needs of the business. Distributions made by a corporation shortly after the close of its taxable year shall be taken into consideration in determining the reasonableness of the amount of earnings and profits of the corporation retained by it for such year. Undistributed income is properly accumulated if invested in increased inventories or additions to plant reasonably needed by the business. It is properly accumulated if retained for working capital required by the business or in accordance with contract obligations placed to the credit of a sinking fund for the purpose of retiring

bonds issued by the corporation. In the case of a banking institution the business of which is to receive and loan money, using capital, surplus, and deposits for that purpose, undistributed income actually represented by loans or reasonably retained for future loans is not accumulated beyond the reasonable needs of the business. The nature of the investment of gains and profits is immaterial if they are not in fact needed in the business. It is an unreasonable accumulation of gains and profits by corporations with the purpose of enabling their shareholders to escape surtaxes on such gains and profits which subjects such corporations to the additional tax imposed by section 104. Among other things, the financial condition of the corporation at the close of the taxable year and the manner in which its funds are invested at that date, determine the reasonableness of the accumulations.

For the purpose of section 104 the term "net income" means the net income of the corporation as defined in section 21 increased by the sum of (1) the amount received as dividends and allowed as a deduction by section 23 (p), plus (2) the amount of interest on obligations of the United States issued after September 1, 1917, which would be subject to tax in whole or in part in the hands of an individual owner. The Commissioner, or any collector upon direction from the Commissioner, may require any corporation to furnish a statement of its accumulated gains and profits, the name and address of, and number of shares held by, each of its shareholders, and the amounts that would be payable to each, if the income of the corporation were distributed. (See section 149 (c).)

Revenue Act of June 6, 1932 (H. R. 10236), Title I, 47 Statutes at Large, p. 195.

SEC. 104. ACCUMULATION OF SURPLUS TO EVADE SURTAXES.

(a) If any corporation, however created or organized, is formed or availed of for the purposes of preventing the imposition of the surtax upon its shareholders through the medium of permitting its gains and profits to accumulate instead of being divided or distributed, there shall be levied, collected, and paid for each taxable year upon the net income of such corporation a tax equal to 50 per centum of the amount thereof, which shall be in addition to the tax imposed by section 13 and shall be computed, collected, and paid upon the same basis and in the same manner and subject to the same provisions of law, including penalties, as that tax.

(b) The fact that any corporation is a mere holding or investment company, or that the gains or profits are permitted to accumulate beyond the reasonable needs of the business, shall be *prima facie* evidence of a purpose to escape the surtax.

(c) As used in this section the term "net income" means the net income as defined in section 21, increased by the sum of the amount of the dividend deduction allowed under section 23(p) and the amount of the interest on obligations of the United States issued after September 1, 1917, which would be subject to tax in whole or in part in the hands of an individual owner.

(d) The tax imposed by this section shall not apply if all the shareholders of the corporation include (at the time of filing their returns) in their gross income their entire distributive shares, whether distributed or not, of the net income of the corporation for such year. Any amount so included in the gross income of a shareholder shall be treated as a dividend received. Any subsequent distribu-

tion made by the corporation out of the earnings or profits for such taxable year shall, if distributed to any shareholder who has so included in his gross income his distributive share, be exempt from tax in the amount of the share so included.

Revenue Act of May 10, 1934 (H. R. 7835), Title I, 48 Statutes at Large, pp. 702 and 751.

SEC. 102. SURTAX ON CORPORATION IMPROPERLY ACCUMULATING SURPLUS.

(a) IMPOSITION OF TAX.—There shall be levied, collected, and paid for each taxable year upon the adjusted net income of every corporation (other than a personal holding company as defined in section 351) if such corporation, however created or organized, is formed or availed of for the purpose of preventing the imposition of the surtax upon its shareholders or the shareholders of any other corporation, through the medium of permitting gains and profits to accumulate instead of being divided or distributed, a surtax equal to the sum of the following:

(1) 25 per centum of the amount of the adjusted net income not in excess of $100,000, plus

(2) 35 per centum of the amount of the adjusted net income in excess of $100,000.

(b) PRIMA FACIE EVIDENCE.—The fact that any corporation is a mere holding or investment company, or that the gains or profits are permitted to accumulate beyond the reasonable needs of the business, shall be *prima facie* evidence of a purpose to avoid surtax.

(c) DEFINITION OF "ADJUSTED NET INCOME".—As used in this section, the term "adjusted net income" means the net income computed without the allowance of the dividend deduction otherwise allowable, but diminished by the amount of dividends paid during the taxable year.

(d) PAYMENT OF SURTAX ON PRO RATA SHARES.—The tax imposed by this section shall not apply if all the shareholders of the corporation include (at the time of filing their returns) in their gross income their entire pro rata shares, whether distributed or not, of the "adjusted net income" of the corporation for such year. Any amount so included in the gross income of a shareholder shall be treated as a dividend received. Any subsequent distribution made by the corporation out of earnings or profits for such taxable year shall, if distributed to any shareholder who has so included in his gross income his pro rata share, be exempt from tax in the amount of the share so included.

(e) TAX ON PERSONAL HOLDING COMPANIES.—For surtax on personal holding companies, see section 351.

SEC. 351. SURTAX ON PERSONAL HOLDING COMPANIES.

(a) IMPOSITION OF TAX.—There shall be levied, collected, and paid, for each taxable year, upon the undistributed adjusted net income of every personal holding company a surtax equal to the sum of the following:

(1) 30 per centum of the amount thereof not in excess of $100,000; plus

(2) 40 per centum of the amount thereof in excess of $100,000.

(b) DEFINITIONS.—As used in this title—

(1) The term "personal holding company" means any corporation (other than a corporation exempt from taxation under section 101, and other than a bank or trust company incorporated under the laws of the United States or of any State or Territory, a substantial part of whose business is the receipt of deposits, and other than a life-insurance company or surety company) if—(A) at least

80 per centum of its gross income for the taxable year is derived from royalties, dividends, interest, annuities, and (except in the case of regular dealers in stock or securities) gains from the sale of stock or securities, and (B) at any time during the last half of the taxable year more than 50 per centum in value of its outstanding stock is owned, directly or indirectly, by or for not more than five individuals. For the purpose of determining the ownership of stock in a personal holding company—(C) stock owned, directly or indirectly, by a corporation, partnership, estate, or trust shall be considered as being owned proportionately by its shareholders, partners, or beneficiaries; (D) an individual shall be considered as owning, to the exclusion of any other individual, the stock owned, directly or indirectly, by his family, and this rule shall be applied in such manner as to produce the smallest possible number of individuals owning, directly or indirectly, more than 50 per centum in value of the outstanding stock; and (E) the family of an individual shall include only his brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants.

(2) The term "undistributed adjusted net income" means the adjusted net income minus the sum of:

(A) 20 per centum of the excess of the adjusted net income over the amount of dividends received from personal holding companies which are allowable as a deduction for the purposes of the tax imposed by section 13 or 204;

(B) Amounts used or set aside to retire indebtedness incurred prior to January 1, 1934, if such amounts are reasonable with reference to the size and terms of such indebtedness; and

(C) Dividends paid during the taxable year.

(3) The term "adjusted net income" means the net income computed without the allowance of the dividend deduction otherwise allowable, but minus the sum of:

(A) Federal income, war-profits, and excess-profits taxes paid or accrued, but not including the tax imposed by this section;

(B) Contributions or gifts, not otherwise allowed as a deduction, to or for the use of donees described in section 23(o) for the purposes therein specified; and

(C) Losses from sales or exchanges of capital assets which are disallowed as a deduction by section 117(d).

(4) The terms used in this section shall have the same meaning as when used in Title I.

(c) ADMINISTRATIVE PROVISIONS.—All provisions of law (including penalties) applicable in respect of the taxes imposed by Title I of this Act, shall insofar as not inconsistent with this section, be applicable in respect of the tax imposed by this section, except that the provisions of section 131 of that title shall not be applicable.

(d) PAYMENT OF SURTAX ON PRO RATA SHARES.—The tax imposed by this section shall not apply if all the shareholders of the corporation include (at the time of filing their returns) in their gross income their entire pro rata shares, whether distributed or not, of the "adjusted net income" of the corporation for such year. Any amount so included in the gross income of a shareholder shall be treated as a dividend received. Any subsequent distribution made by the corporation out of earnings or profits for such taxable year shall, if distributed to any shareholder who has so included in his gross income his pro rata share, be exempt from tax in the amount of the share so included.

(e) IMPROPER ACCUMULATION OF SURPLUS.—For surtax on corporations which accumulate surplus to avoid surtax on stockholders, see section 102.

Revenue Act of August 30, 1935 (H. R. 8974), Title I, 49 Statutes at Large, p. 1674.

SEC. 109. PERSONAL HOLDING COMPANIES.

(a) Section 351(a) of the Revenue Act of 1934 is amended to read as follows:

> "(a) IMPOSITION OF TAX.—There shall be levied, collected, and paid, for each taxable year, upon the undistributed adjusted net income of every personal holding company a surtax equal to the sum of the following:
>
> "(1) 20 per centum of the amount thereof not in excess of $2,000; plus
>
> "(2) 30 per centum of the amount thereof in excess of $2,000 and not in excess of $100,000; plus
>
> "(3) 40 per centum of the amount thereof in excess of $100,000 and not in excess of $500,000; plus
>
> "(4) 50 per centum of the amount thereof in excess of $500,000 and not in excess of $1,000,000; plus
>
> "(5) 60 per centum of the amount thereof in excess of $1,000,000."

(b) Section 351(b)(2)(C) of such Act is amended by striking out the period at the end thereof and inserting in lieu thereof a comma and the following: "and distributions (not in complete or partial liquidation and not a 'dividend' as defined in section 115) made during the taxable year out of earnings or profits of such year."

(c) The amendments made by this section shall apply only in the case of taxable years beginning after December 31, 1935.

On March 3, 1936, President Roosevelt in a letter to the Congress said:

> "The accumulation of surplus in corporations controlled by taxpayers with large incomes is encouraged by the present freedom of undistributed corporate income from surtaxes. Since stockholders are the beneficial owners of both distributed and undistributed corporate income, the aim, as a matter of fundamental equity, should be to seek equality of tax burden on all corporate income whether distributed or withheld from the beneficial owners. As the law now stands our corporate taxes dip too deeply into the shares of corporate earnings going to stockholders who need the disbursement of dividends, while the shares of stockholders who can afford to leave earnings undistributed escape current surtaxes altogether.
>
> This method of evading existing surtaxes constitutes a problem as old as the income-tax law itself. Repeated attempts by the Congress to prevent this form of evasion has not been successful. The evil has been a growing one. It has now reached disturbing proportions from the standpoint of the inequality it represents and of its serious effect on the Federal revenue. Thus the Treasury estimates that, during the calendar year 1936, over 4½ billion dollars of corporate income will be withheld from stockholders. If this undistributed income were distributed, it would be added to the income of stockholders and there taxed as is other personal income. But, as matters now stand, it will be withheld from stockholders by those in control of these corporations. In one year alone, the Government will be deprived of revenues amounting to over $1,300,000,000.
>
> A proper tax on corporate income (including dividends from other corporations), which is not distributed as earned, would correct the serious twofold inequality in our taxes on business profits if accompanied by a repeal of the present corporate income tax, the capital-stock tax, the related excess-profit tax, and the present exemption of dividends from the normal tax on individual incomes. The rate on undis-

tributed corporate income should be graduated and so fixed as to yield approximately the same revenue as would be yielded if corporate profits were distributed and taxed in the hands of stockholders.

Such a revision of our corporate taxes would effect great simplification in tax procedure, in corporate accounting, and in the understanding of the whole subject by the citizens of the Nation. It would constitute distinct progress in tax reform'' (see Report of the Committee on Ways and Means to the House of Representatives to accompany H. R. 12395 Revenue Act of 1936).

Revenue Act of June 22, 1936 (H. R. 12395), Title I, 49 Statutes at Large, pp. 1655, 1676 and 1732.

SEC. 14. SURTAX ON UNDISTRIBUTED PROFITS.

(a) DEFINITIONS.—As used in this title—

(1) The term ''adjusted net income'' means the net income minus the sum of—

(A) The normal tax imposed by section 13.

(B) The credit provided in section 26 (a), relating to interest on certain obligations of the United States and Government corporations.

(C) In the case of a holding company affiliate (as defined in section 2 of the Banking Act of 1933), the amount allowed as a credit under section 26(d).

(D) In the case of a national mortgage association created under Title III of the National Housing Act, the amount allowed as a credit under section 26 (e).

(2) The term ''undistributed net income'' means the adjusted net income minus the sum of the dividends paid credit provided in section 27 and the credit provided in section 26 (c), relating to contracts restricting dividends.

(b) IMPOSITION OF TAX.—There shall be levied, collected, and paid for each taxable year upon the net income of every corporation a surtax equal to the sum of the following, subject to the application of the specific credit as provided in subsection (c):

7 per centum of the portion of the undistributed net income which is not in excess of 10 per centum of the adjusted net income.

12 per centum of the portion of the undistributed net income which is in excess of 10 per centum and not in excess of 20 per centum of the adjusted net income.

17 per centum of the portion of the undistributed net income which is in excess of 20 per centum and not in excess of 40 per centum of the adjusted net income.

22 per centum of the portion of the undistributed net income which is in excess of 40 per centum and not in excess of 60 per centum of the adjusted net income.

27 per centum of the portion of the undistributed net income which is in excess of 60 per centum of the adjusted net income.

(c) ADJUSTED NET INCOME LESS THAN $50,000.—

(1) SPECIFIC CREDIT.—If the adjusted net income is less than $50,000, there shall be allowed a specific credit equal to the portion of the undistributed net income which is in excess of 10 per centum of the adjusted net income and not in excess of $5,000, such credit to be applied as provided in paragraph (2).

(2) APPLICATION OF SPECIFIC CREDIT.—If the corporation is entitled to a specific credit, the tax shall be equal to the sum of the following:

(A) A tax computed under subsection (b) upon the amount of the undistributed net income reduced by the amount of the specific credit, plus

(B) 7 per centum of the amount specific credit.

(d) EXEMPTION FROM SURTAX.—The following corporations shall not be subject to the surtax imposed by this section:

(1) Banks as defined in section 104.

(2) Domestic corporations which for any portion of the taxable year are in bankruptcy under the laws of the United States, or are insolvent and in receivership in any court of the United States or of any State, Territory, or the District of Columbia.

(3) Insurance companies subject to the tax imposed under section 201, 204, or 207.

(4) Foreign corporations.

(5) Corporations which, by reason of deriving a large portion of their gross income from sources within a possession of the United States, are entitled to the benefits of section 251.

(6) Corporations organized under the China Trade Act, 1922.

(7) Joint Stock Land Banks organized under the Federal Farm Loan Act, as amended.

(e) EXEMPT CORPORATIONS.—For corporations exempt from taxation under this title, see section 101.

(f) TAX ON PERSONAL HOLDING COMPANIES.—For surtax on personal holding companies, see section 351.

(g) IMPROPER ACCUMULATION OF SURPLUS.—For surtax on corporations which accumulate surplus to avoid surtax on stockholders, see section 102.

SEC. 102. SURTAX ON CORPORATIONS IMPROPERLY ACCUMULATING SURPLUS.

(a) IMPOSITION OF TAX.—There shall be levied, collected, and paid for each taxable year (in addition to other taxes imposed by this title) upon the net income of every corporation (other than a personal holding company as defined

in section 351) if such corporation, however created or organized, is formed or availed of for the purpose of preventing the imposition of the surtax upon its shareholders or the shareholders of any other corporation, through the medium of permitting earnings or profits to accumulate instead of being divided or distributed—

(1) In the case of corporations not subject to the surtax on undistributed profits imposed by section 14, a surtax equal to the sum of the following:

25 per centum of the amount of the retained net income not in excess of $100,000, plus

35 per centum of the amount of the retained net income in excess of $100,000.

(2) In the case of corporations subject to the surtax on undistributed profits imposed by section 14, a surtax equal to the sum of the following:

15 per centum of the amount of the retained net income not in excess of $100,000, plus

25 per centum of the amount of the retained net income in excess of $100,000.

(b) PRIMA FACIE EVIDENCE.—The fact that any corporation is a mere holding or investment company, or that the earnings or profits are permitted to accumulate beyond the reasonable needs of the business, shall be *prima facie* evidence of a purpose to avoid surtax upon shareholders.

(c) DEFINITIONS.—As used in this title—

(1) SPECIAL ADJUSTED NET INCOME.—The term "special adjusted net income" means the net income minus the sum of—

(A) TAXES.—Federal income, war-profits, and excess-profits taxes paid or accrued during the taxable year, to the extent not allowed as a deduction by section 23, but not including the tax imposed by this section or a corresponding section of a prior income-tax law.

(B) DISALLOWED CHARITABLE, ETC., CONTRIBUTIONS.—Contributions or gifts, not otherwise allowed as a deduction, to or for the use of donees described in section 23 (o), for the purposes therein specified.

(C) DISALLOWED LOSSES.—Losses from sales or exchanges of capital assets which are disallowed as a deduction by section 117 (d).

(D) BANK AFFILIATES.—In the case of a holding company affiliate (as defined in section 2 of the Banking Act of 1933), the amount allowed as a credit under section 26 (d).

(E) NATIONAL MORTGAGE ASSOCIATIONS.—In the case of a national mortgage association created under Title III of the National Housing Act, the amount allowed as a credit under section 26 (e).

(2) RETAINED NET INCOME.—The term "retained net income" means the special adjusted net income minus the sum of the dividends paid credit provided in section 27 and the credit provided in section 26 (c), relating to contracts restricting dividends. For the purposes of this subsection, such credits shall be computed by substituting in section 26 (c) and in section 27 for the words "adjusted net income" wherever appearing in such sections the words "special adjusted net income".

(d) PAYMENT OF SURTAX ON PRO RATA SHARES.—The tax imposed by this section shall not apply if (1) all the shareholders of the corporation include (at the time of filing their returns) in their gross income their entire pro rata shares, whether distributed or not, of the retained net income of the corporation for such year, and (2) 90 per centum or more of such retained net income is so included in the gross income of shareholders other than corporations. Any amount so included in the gross income of a shareholder shall be treated as a dividend received. Any subsequent distribution made by the corporation out of earnings or profits for such taxable year shall, if distributed

stock in a personal holding company—(C) stock owned, directly or indirectly, by a corporation, partnership, estate, or trust shall be considered as being owned proportionately by its shareholders, partners, or beneficiaries; (D) an individual shall be considered as owning, to the exclusion of any other individual, the stock owned, directly or indirectly, by his family, and this rule shall be applied in such manner as to produce the smallest possible number of individuals owning, directly or indirectly, more than 50 per centum in value of the outstanding stock; and (E) the family of an individual shall include only his brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants.

(2) The term "undistributed adjusted net income" means the adjusted net income minus the sum of:

(A) 20 per centum of the excess of the adjusted net income over the amount of dividends received from personal holding companies which are allowable as a credit for the purposes of the tax imposed by section 13 or 204;

(B) Amounts used or set aside to retire indebtedness incurred prior to January 1, 1934, if such amounts are reasonable with reference to the size and terms of such indebtedness; and

(C) The amount of the dividends paid credit provided in section 27, computed without the benefit of subsection (b) thereof (relating to the dividend carry-over).

(3) The term "adjusted net income" means the net income minus the sum of:

(A) Federal income, war-profits, and excess-profits taxes paid or accrued during the taxable year to the extent not allowed as a deduction by section 23, but not including the tax imposed by this section or a corresponding section of a prior income-tax law;

(B) Contributions or gifts, not otherwise allowed as a deduction, to or for the use of donees

to any shareholder who has so included in his gross income his pro rata share, be exempt from tax in the amount of the share so included.

(e) TAX ON PERSONAL HOLDING COMPANIES.—For surtax on personal holding companies, see section 351.

SEC. 351. SURTAX ON PERSONAL HOLDING COMPANIES.

(a) IMPOSITION OF TAX.—There shall be levied, collected, and paid, for each taxable year (in addition to the taxes imposed by Title I), upon the undistributed adjusted net income of every personal holding company a surtax equal to the sum of the following:

(1) 8 per centum of the amount thereof not in excess of $2,000; plus

(2) 18 per centum of the amount thereof in excess of $2,000 and not in excess of $100,000; plus

(3) 28 per centum of the amount thereof in excess of $100,000 and not in excess of $500,000; plus

(4) 38 per centum of the amount thereof in excess of $500,000 and not in excess of $1,000,000; plus

(5) 48 per centum of the amount thereof in excess of $1,000,000.

(b) DEFINITIONS.—As used in this title—

(1) The term "personal holding company" means any corporation (other than a corporation exempt from taxation under section 101, and other than a bank, as defined in section 104, and other than a life-insurance company or surety company) if—(A) at least 80 per centum of its gross income for the taxable year is derived from royalties, dividends, interest, annuities, and (except in the case of regular dealers in stock or securities) gains from the sale of stock or securities, and (B) at any time during the last half of the taxable year more than 50 per centum in value of its outstanding stock is owned, directly or indirectly, by or for not more than five individuals. For the purpose of determining the ownership of

described in section 23 (o) for the purposes therein specified, including, in the case of a corporation organized prior to January 1, 1936, to take over the assets and liabilities of the estate of a decedent, amounts paid in liquidation of any liability of the corporation based on the liability of the decedent to make any such contribution or gift, to the extent such liability of the decedent existed prior to January 1, 1934; and

(C) Losses from sales or exchanges of capital assets which are disallowed as a deduction by section 117 (d).

(4) The terms used in this section shall have the same meaning as when used in Title I.

(c) ADMINISTRATIVE PROVISIONS.—All provisions of law (including penalties) applicable in respect of the taxes imposed by Title I of this Act, shall insofar as not inconsistent with this section, be applicable in respect of the tax imposed by this section, except that the provisions of section 131 of that title shall not be applicable.

(d) PAYMENT OF SURTAX ON PRO RATA SHARES.—The tax imposed by this section shall not apply if (1) all the shareholders of the corporation include (at the time of filing their returns) in their gross income their entire pro rata shares, whether distributed or not, of the adjusted net income of the corporation for such year, and (2) 90 per centum or more of such adjusted net income is so included in the gross income of shareholders other than corporations. Any amount so included in the gross income of a shareholder shall be treated as a dividend received. Any subsequent distribution made by the corporation out of earnings or profits for such taxable year shall, if distributed to any shareholder who has so included in his gross income his pro rata share, be exempt from tax in the amount of the share so included.

(e) IMPROPER ACCUMULATION OF SURPLUS.—For surtax on corporations which accumulate surplus to avoid surtax on stockholders, see section 102.

Speaking on the 1936 law in the Senate, Senator George (Congressional Record—Senate—1936—Volume 80, page 8804) said:

> "I now come to a point which the Treasury officials have not properly evaluated. It is a point to which they either overlooked or did not properly weigh, as it seems to me. The English corporations have withheld a greater percentage of their earnings than the American corporations. How is that accounted for? It is accounted for by one fact, which ought not to be lost sight of, and that is that corporate dividends or earnings are not necessarily withheld for the purpose of tax avoidance, but they are withheld because, as a matter of judgment and of sound business, it is of actual profit in the administration of the corporations to do so. Let the Senate bear that fact in mind. Under the nearest comparable system to ours there is no inducement to tax avoidance, because the tax must be paid if distributed to the individuals, and must be paid also by the corporation if withheld.
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> Mr. President, there is one other feature of the subject that I wish to discuss, because I desire to be fair. Because there is opportunity for tax avoidance by those taxpayers who, if the earnings of corporations were distributed, would be called upon to pay a much higher tax then they would pay when the earnings are permitted to be plowed back or to remain in the corporation, and because the Treasury has suffered by reason of the acts of some who have abused our present law, is no sufficient reason why we should look with a narrow and contracted vision at those particular offenders and make laws that apply to the corporation that is actually withholding its income for legitimate purposes, for the purpose of

carrying forward its program, for the purpose of employing men, for the purpose, Mr. President, of making it possible again to afford employment to all the people of the United States. In other words, we cannot afford to depart from a tried and established basis of taxation and embark on an untried experimental program because we are aggravated or annoyed somewhat on account of the conduct of a relatively few corporations in the United States."

SUPREME COURT OF THE UNITED STATES.

No. 723.—October Term, 1937.

Guy T. Helvering, Commissioner, etc., Petitioner, vs. National Grocery Company.	On Certiorari to the United States Circuit Court of Appeals for the Third Circuit.

[May 16, 1938.]

Mr. Justice Brandeis delivered the opinion of the Court.

National Grocery Company is a New Jersey corporation, which operates chain stores. Since 1911 it has had $200,000 capital stock, all owned beneficially by Henry Kohl. In the year ending January 31, 1931, the corporation's books showed a net profit of $682,850.38, after paying $104,000 to Kohl as salary and the regular federal corporation income tax of 12 per cent. Its surplus, as shown by its books, increased during the year from $7,245,824.26 to $7,938,965.54; that is $693,141.28. It paid no dividend.

Section 104 of the Revenue Act of 1928, c. 852, 45 Stat. 814, provides:

"(a) If any corporation, however created or organized, is formed or availed of for the purpose of preventing the imposition of the surtax upon its shareholders through the medium of permitting its gains and profits to accumulate instead of being divided or distributed, there shall be levied, collected and paid for each taxable year upon the net income of such corporation a tax equal to 50 per centum of the amount thereof, which shall be in addition to the tax imposed by Section 13. . . .

"(b) The fact . . . that the gains or profits are permitted to accumulate beyond the reasonable needs of the business, shall be prima facie evidence of a purpose to escape the surtax."

The Commissioner of Internal Revenue, having found that the corporation had been availed of for the purpose of preventing the imposition of the surtax upon Kohl by permitting the gains and profits to accumulate, assessed upon it, under Section 104, a deficiency tax of $477,322.81 for the tax year, in addition to the regular corporation income tax, which had been paid. This amount, together with $37.87 admittedly due, constitutes the total deficiency assessment of $477,360.68.

The corporation petitioned for a redetermination by the Board of Tax Appeals. Before the Board a large volume of evidence

was introduced which had not been submitted to the Commissioner. It detailed, among other things, the financial history of the business from its inception. There were 35 elaborate exhibits, many of them prepared from the books with the co-operation of the counsel for the corporation and for the Commissioner. Twenty-four of the exhibits were introduced by the taxpayer; eleven by the Commissioner. The taxpayer also presented as witnesses Kohl and the treasurer of the corporation, who testified orally to the history of the business, its practices and aims; local bank officials who testified as experts to the wisdom of accumulating the profits; and other experts who testified to the depreciation in 1930 of the market value of the securities held by the corporation and of its real estate. The Board, by a bare majority,[1] sustained the Commissioner's determination. In stating its conclusions, it found as follows:

"We find as a fact that the petitioner's accumulation of earnings was far in excess of the 'reasonable needs' of the corporate business.

"We are also of opinion that the evidence of record does not rebut the prima facie presumption created by the statute that the accumulation of earnings beyond the 'reasonable needs of the business' was for the purpose of preventing the imposition of the surtax upon its sole stockholder. . . .

"Upon the evidence before us we have made the finding that the petitioner was 'availed of' during the fiscal year ended January 31, 1931, for the purpose of preventing the imposition of the surtax upon its sole stockholder 'through the medium of permitting its gains and profits to accumulate instead of being divided or distributed.'"

The corporation then petitioned for a review by the Circuit Court of Appeals. It reversed the order of the Board; and did so on the ground that there was before the Board "no proof, substantial or otherwise, to support its imposition of" the tax. Certiorari was sought by the Commissioner, who urged that in so deciding the court had departed from the accepted and usual course of judicial proceedings. We granted certiorari because of the importance in the administration of the revenue laws of the matter presented. 302 U. S. —.

[1] Mr. Mellott, who stated the views of the minority, said: "This being a 'fact case', it is with some reluctance that I reach a conclusion at variance with that of the Member who heard the testimony of the witnesses and had the advantage of observing their manner and demeanor while testifying. . . ."

The corporation makes here two contentions in support of the judgment which were not discussed by the Court of Appeals. It challenges the constitutionality of the statute and also urges that in holding that there were "gains and profits" the Commissioner and the Board of Tax Appeals misconstrued the statute. These contentions will be considered before examining the alleged lack of evidence to support the findings of the Board.

First. The National Grocery Company concedes that Section 104 is constitutional as applied to a corporation organized for the purpose of preventing the imposition of surtaxes upon its shareholders;[2] but urges five reasons why it should be held void as applied to a legitimate business corporation which is "availed of" for the forbidden purpose. None of these reasons is sound.

1. It is said that the statute violates the Tenth Amendment because it interferes with the power to declare or to withhold dividends—a power which the State conferred upon the corporation. The statute in no way limits the powers of the corporation. It merely lays the tax upon corporations which use their powers to prevent imposition upon their stockholders of the federal surtaxes. "Congress in raising revenue has incidental power to defeat obstructions to that incidence of taxes which it chooses to impose." *United Business Corporation* v. *Commissioner*, 62 F. (2d) 754, 756.

Kohl's personal income tax for the calendar year 1931 was $32,034.74. If he had included in his personal return of taxable income the corporation's entire net income for the fiscal year 1930-1931, an additional tax upon him of over $115,000 would have been due;[3] and no tax would have been assessable against the corporation

[2] Citing United Business Corporation *v.* Commissioner, 62 F. (2d) 754 (C. C. A. 2); A. D. Saenger, Inc. *v.* Commissioner, 84 F. (2d) 23 (C. C. A. 5); Almours Securities, Inc. *v.* Commissioner, 91 F. (2d) 427 (C. C. A. 5); Williams Inv. Co. *v.* United States, 3 F. Supp. 225 (Ct. Cl.). See also United States *v.* R. C. Tway Coal Co., 75 F. (2d) 336 (C. C. A. 6); Keck Inv. Co. *v.* Commissioner, 77 F. (2d) 244 (C. C. A. 9).

[3] It is not possible to calculate what Kohl's exact additional surtax liability would have been had he included the corporation's income for 1930-1931 in his personal return for 1931, since that return is not in evidence. A minimum figure, however, may be obtained. The corporation's "net income", as defined in § 104, was $954,645.62. There must be deducted from this $103,654.47 for corporation income tax; and $100,000 was distributed as a dividend in 1931 and included in computing the tax paid by Kohl in that year. Even assuming that the remaining $750,991.15 would have constituted his entire net income for 1931, and that the maximum deduction of 15% of this amount for charitable contributions could have been taken, a surtax of $119,328.50 would have been due.

under Section 104. For the statute expressly provides, in paragraph (d), that the corporation shall not be so taxed, if the stockholders make the return required to ensure the surtax:

"(d) The tax imposed by this section shall not apply if all the shareholders of the corporation include (at the time of filing their returns) in their gross income their entire distributive shares, whether distributed or not, of the net income of the corporation for such year. Any amount so included in the gross income of a shareholder shall be treated as a dividend received. Any subsequent distribution made by the corporation out of the earnings or profits for such taxable year shall, if distributed to any shareholder who has so included in his gross income his distributive share, be exempt from tax in the amount of the share so included."

2. It is said that the statute is unconstitutional because the liability imposed is not a tax upon income, but a penalty designed to force corporations to distribute earnings in order to create a basis for taxation against the stockholders. If the business had been carried on by Kohl individually all the year's profits would have been taxable to him. If, having a partner, the business had been carried on as a partnership, all the year's profits would have been taxable to the partners individually, although these had been retained by the partnership undistributed. See *Heiner* v. *Mellon*, Nos. 144 and 145, decided May 16, 1938. Kohl, the sole owner of the business, could not by conducting it as a corporation, prevent Congress, if it chose to do so, from laying on him individually the tax on the year's profits.[4] If it preferred, Congress could lay the tax upon the corporation, as was done by Section 104. The penal nature of the imposition does not prevent its being valid, as the

[4] The first statute which provided for taxation where corporate profits are accumulated for the purpose of preventing the imposition of surtaxes upon stockholders was the Tariff Act of 1913, Section 2A, subdiv. 1, 38 Stat. 166. In that Act, in the Revenue Act of 1916, § 3; 39 Stat. 758, and in the Revenue Act of 1918, § 220, 40 Stat. 1072, the tax was laid upon the shareholder. In all later Revenue Acts, the tax is laid upon the corporation. 1921 Act, § 220, 42 Stat. 247; 1924 Act, § 220, 43 Stat. 277; 1926 Act, § 220, 44 Stat. 34; 1928 Act, § 104, 45 Stat. 814; 1932 Act, § 104, 47 Stat. 195; 1934 Act, § 102, 48 Stat. 702; 1936 Act, § 102, 49 Stat. 1676.

The Revenue Acts of 1918 and 1921, §§ 218(e) and 218(d), respectively, also taxed the shareholders of "personal service corporations" like partners. Section 112(k) of the Revenue Act of 1932 and § 112(i) of the Acts of 1934 and 1936 provide for the disregard of the corporate entity in certain cases where foreign corporations are used for the purpose of avoiding federal taxes. And § 201 of the Revenue Act of 1937, 50 Stat. 818, provides that the adjusted undistributed net income of foreign personal holding companies must be included in the gross income of their United States shareholders. Compare also Southern Pac. Co. v. Lowe, 247 U. S. 330, 336; Gulf Oil Corp. v. Lewellyn, 248 U. S. 71; Gregory v. Helvering, 293 U. S. 465.

tax was otherwise permissible under the Constitution. Compare *Helvering* v. *Mitchell*, 303 U. S. —.

3. It is said that Section 104 is unconstitutional because the liability is laid upon the mere purpose to prevent imposition of the surtaxes, not upon the accomplishment of that purpose; and that, thus, it is a direct tax on the state of mind. But this is not so. The tax is laid "upon the net income of such corporation". The existence of the defined purpose is a condition precedent to the imposition of the tax liability, but this does not prevent it from being a true income tax within the meaning of the Sixteenth Amendment. The instances are many in which purpose or state of mind determines the incidence of an income tax.[5]

4. It is said that Section 104 as applied deprived the corporation of its property without due process of law; that it is unreasonable, arbitrary and capricious in that no standard or formula is specified to guide the Commissioner in assessing, or the corporate directors in avoiding, the additional tax; that it is assessed retroactively; and that it is unfair to non-assenting minority stockholders. The prescribed standard is not too vague. As Judge Learned Hand said in *United Business Corporation* v. *Commissioner*, 62 F. (2d) 754, 756:

"Standards of conduct, fixed no more definitely, are common in the law; the whole law of torts is pervaded by them; much of its commands are that a man must act as the occasion demands, the standard being available to all. The vice of fixing maximum prices is that it requires recourse to standards beyond ascertainment by sellers, by which therefore they cannot in practice regulate their

[5] For example, § 293(b) of the Revenue Act of 1928 provides that if any part of a deficiency is due to "fraud with intent to evade tax", there shall be an "addition to the tax" of 50% of the deficiency. Helvering v. Mitchell, 303 U. S. —. Whether a payment received is compensation within § 22(a) or is a gift within § 22(b)(3) is largely a matter of intention. Compare Bogardus v. Commissioner, 302 U. S. 34, 45. Similarly, the deductibility of losses under § 23(e) may depend upon whether the taxpayer's motive in entering into the transaction was primarily profit. Compare Heiner v. Tindle, 276 U. S. 582; Stuart v. Commissioner, 84 F. (2d) 368 (C. C. A. 1); Goldsborough v. Burnet, 46 F. (2d) 432 (C. C. A. 4); Beaumont v. Helvering, 73 F. (2d) 110, 113 (App. D. C.); Dresser v. United States, 55 F. (2d) 499 (Ct. Cl.). And § 112(k) of the Revenue Act of 1932 (and § 112(i) of the Acts of 1934 and 1936) provides that a foreign corporation shall not be considered as a corporation for purposes of certain of the non-recognition provisions of that section unless "it has been established to the satisfaction of the Commissioner that such exchange or distribution is not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes."

dealings. That is not true of the reasonable needs of a business, which is immediately within the ken of the managers, the supposititious standard, though indeed objective, being as accessible as those for example of the prudent driving of a motor car, or of the diligence required in making a ship seaworthy, or of the extent of proper inquiry into the solvency of a debtor."

Clearly retroactive assessment is no more objectionable here than in the case of penalties for fraud or negligence. *Helvering* v. *Mitchell, supra.* And since no minority stockholders are here involved, the last objection need not be considered. *Castillo* v. *McConnico,* 168 U. S. 674, 680; *Atlantic Refining Co.* v. *Virginia,* 302 U. S. 22, 27.

5. It is said that Section 104 is void because it delegates to the Commissioner legislative power. The statute provides that if the corporation is availed of for the forbidden purpose, the tax "shall be levied, collected, and paid"; and certain facts are made prima facie evidence of the existence of this purpose. No power is delegated to the Commissioner save that of finding facts upon evidence.

Second. The corporation contends, as a matter of statutory construction, that Section 104 was not applicable because there were no "gains and profits" within the tax year. Conceding that net income of $863,787.22 was earned,[6] it asserts that there were "no gains and profits" because the depreciation in the securities owned, none of which were sold, exceeded $2,000,000. The argument is that the word "gains" was not used as synonymous with "profits", but to express contemplated unrealized increases or accession in net worth of the assets; and that assessability under Section 104 depends not upon gains or profits—but upon the aggregate of gains (or losses) and profits, since prudent directors would take these into consideration in determining whether a dividend should be declared. Depreciation in any of the assets is evidence to be considered by the Commissioner and the Board in determining the issue of fact whether the accumulation of profits was in excess of the reasonable needs of the business. But obviously depreciation in the market value of securities which the corporation continues to hold does not, as matter of law, preclude a finding that the accumulation of the year's profits was in excess of the reasonable needs of the business.

[6] The corporation reported in its return an income of $863,471.67. This was increased by the Commissioner to $863,787.22, and is not now disputed.

Third. There was ample evidence to support the findings of the Board of Tax Appeals. The corporation held on January 31, 1930, bonds and stocks valued at $2,779,718.07; on January 31, 1931 it held $2,989,452.74—an increase of $209,734.67. The list of these bonds and stocks showed that they were in no way related to a grocery business.[7] That there was no need of accumulating any part of the year's earnings for the purpose of financing the business was shown by the balance sheet. Comparing the cash on hand with the outstanding indebtedness, it appears that the $1,332,332.28 cash on hand January 31, 1930 exceeded the $1,161,121.96 accounts payable, notes and mortgage, by $171,210.32. On January 31, 1931, the excess of cash over accounts payable was $1,136,820.55. These were then only $269,140.49; and the cash on hand was $1,405,961.04. The notes payable and the mortgage had been discharged.

That the purpose of accumulating this huge surplus was to escape the imposition upon Kohl of surtaxes, was indicated by the following facts. The $4,395,413.78 aggregate of bonds, stocks, and excess cash January 31, 1931, represents about four-fifths of the total accumulation of the surplus profits during the last ten years, which amounted to $5,742,455.35.[8] If the surplus profits of the fiscal year 1930-1931 had been distributed as dividends, the additional surtaxes payable thereon by Kohl in the year 1931 would have been at least $90,744.56, and for the preceding nine years would have aggregated $1,240,852.30.[9]

Further evidence to support the Board's findings that in the tax year dividends were omitted and the surplus accumulated in order to enable Kohl to escape these surtaxes is furnished by the following facts: Kohl drew his salary of $104,000 a year; and that sum, as an

[7] The stock held January 31, 1931, of the aggregate cost of $2,676,061.47, consisted of issues of 147 different corporations. Of industrials there were 61. Of public utilities, 27. Of insurance companies, 18. Of investment trusts, 13. Of banks and trust companies, 28. There were, besides, government, municipal, railroad, public utility, industrial and miscellaneous bonds which cost $313,391.27.

[8] The profits for these years (after deducting federal corporation income taxes paid) are listed in note 9, *infra*.

[9] Kohl's individual returns were made on a calendar year cash basis. For the fiscal year here in question, January 31, 1930 to January 31, 1931, the corporation's books showed a profit of $682,850.38 after deducting Kohl's salary and the 12% corporation income tax paid. A dividend of $100,000 was paid in 1931. Had the remaining $582,850.38 been entirely distributed in that year, Kohl would have incurred an additional surtax liability of $90,744.56, even if it be assumed that the additional distribution would have

expense of the business, was deducted before calculating the corporation's profit on which it paid taxes under Section 13. He needed personally further sums and took these in the form of loans. In the tax year Kohl borrowed from the corporation $140,000. His aggregate indebtedness on January 31, 1931 for borrowings during seven years, was $610,000. As was stated in *United Business Corporation* v. *Commissioner, supra,* p. 755: "These loans are incompatible with a purpose to strengthen the financial position of the petitioner, but entirely accord with a desire to get the equivalent of his dividends under another guise."[10]

Since Kohl was the sole owner of the corporation, the business would have been as well protected against unexpected demands for capital, and assured of capital for the purpose of any possible expansion, by his personal ownership of the securities as by the corporation's owning them. Moreover, no conceivable expansion could

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constituted his entire net income for that year and that the 15% maximum charitable contributions deduction could have been taken. (It is impossible to calculate what his exact surtax liability for 1931 would have been, inasmuch as his personal return for that year is not in evidence.) Compare note 3, *supra.*

If the corporation had distributed its profits for each fiscal year immediately after its close on January 31, Kohl's additional surtax liability for the nine preceding years would have been as follows:

Year	Fiscal Year in Which Distribution Was Earned by Corporation	Book Profits of Corporation Less Federal Corporation Income Tax Paid	Kohl's Computed Net Income Including Distribution	Kohl's Computed Surtax	Surtax Actually Paid	Difference
1930	Jan. 31, 1929–Jan. 31, 1930	$713,181.62	$703,972.52	$132,454.50	$8,022.37	$124,432.13
1929	Jan. 31, 1928–Jan. 31, 1929	769,945.96	839,766.18	159,613.24	8,441.14	151,172.10
1928	Jan. 31, 1927–Jan. 31, 1928	707,289.60	775,363.34	146,732.67	8,411.75	138,320.92
1927	Jan. 31, 1926–Jan. 31, 1927	498,879.08	569,440.88	105,548.18	8,481.21	97,066.97
1926	Jan. 31, 1925–Jan. 31, 1926	508,837.06	584,937.44	108,647.49	9,113.16	99,534.33
1925	Jan. 31, 1924–Jan. 31, 1925	528,022.34	614,044.69	114,468.94	9,004.24	105,464.70
1924	Jan. 31, 1923–Jan. 31, 1924	547,483.80	546,921.87	188,788.75	2,820.60	185,968.15
1923	Jan. 31, 1922–Jan. 31, 1923	461,106.88	441,832.17	191,876.09	2,069.50	189,806.59
1922	Jan. 31, 1921–Jan. 31, 1922	324,908.63	362,986.22	152,453.11	3,366.70	149,086.41
						$1,240,852.80

[10] Compare A. D. Saenger, Inc. v. Commissioner, 84 F. (2d) 23 (C. C. A. 5); United States v. R. C. Tway Coal Co., 75 F. (2d) 336, 340 (C. C. A. 6).

have utilized so large a surplus.[11] The high taxes were first imposed in 1919.[12] After that time no dividend was paid until after the close of the taxable year here involved.

Thus, independently of the presumption prescribed in Section 104(b) there was ample evidence to support the Board's findings.

Fourth. The Court of Appeals, instead of limiting its review to ascertaining whether there was evidence to support the Board's findings and decision, made on all the evidence, as upon a trial *de novo,* in effect, an independent determination of the matters which had been in issue before the Board. The court was without power to do so. *Helvering* v. *Rankin,* 295 U. S. 123, 131-32. To draw inferences, to weigh the evidence and to declare the result was the function of the Board. *Hulburd* v. *Commissioner,* 296 U. S. 300, 306; *Elmhurst Cemetery Co.* v. *Commissioner,* 300 U. S. 37, 40.

Fifth. The court expressed the opinion that the Board failed to consider relevant and controlling facts, that it relied upon improper evidence in reaching its conclusion, and that it failed to make the findings required by the statute. There is nothing in the record to justify that view. The findings quoted above are specific. The Board was not obliged to accept as true Kohl's statement of his intention and purposes; or to accept as sound the opinion of his experts. It was error to reverse the decision of the Board. There is no occasion to remand the case to it for further consideration.

Reversed.

Mr. Justice McREYNOLDS and Mr. Justice BUTLER are of opinion that the judgment below should be affirmed.

Mr. Justice CARDOZO and Mr. Justice REED took no part in the consideration or decision of this case.

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[11] In the ten years the number of stores in the chain had been increased from 358 to 815. Even on Kohl's own estimate that "including everything you have to have about $5000 per store", this expansion could account for only $2,285,000 of the $5,742,455.35 of profits accumulated over that period.

[12] The Revenue Act of 1918, 40 Stat. 1057, which was not enacted until February 24, 1919, imposed a surtax of as much as 65% on income in excess of $1,000,000. The maximum rate under the Revenue Act of 1916, 39 Stat. 756, was only 13% on income in excess of $2,000,000.